2006

Annual Report and Accounts
The Hongkong and Shanghai Banking Corporation Limited

The world's local bank

HSBC

Annual Report and Accounts 2006

Contents

A Chinese translation of the *Annual Report and Accounts* is available upon request from: Group Public Affairs, 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.asiapacific.hsbc.com.

*本年報及結算表*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 樓集團公共事務部。本年報之中英文本亦載於本行之網址 www.asiapacific.hsbc.com。

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Financial Highlights: The Hongkong and Shanghai Banking Corporation Limited and Subsidiaries

	2006	2005
For the year	**HK$m**	HK$m
Net operating income before loan impairment charges	**92,325**	77,222
Profit before tax	**52,016**	45,249
Profit attributable to shareholders	**37,709**	32,873
At year-end		
Shareholders' equity	**145,450**	97,334
Total equity	**165,445**	114,425
Total regulatory capital	**183,981**	154,065
Customer accounts	**1,989,467**	1,735,110
Total assets	**3,150,840**	2,672,532
Risk-weighted assets	**1,367,607**	1,238,164
Ratios	%	%
Return on average shareholders' equity	**31.1**	37.4
Post-tax return on average total assets	**1.46**	1.44
Cost efficiency ratio	**41.4**	41.2
Net interest margin	**2.31**	2.14
Capital adequacy ratios		
– total capital	**13.5**	12.4
– tier 1 capital	**12.3**	11.7

Established in Hong Kong and Shanghai in 1865, The Hongkong and Shanghai Banking Corporation Limited is the founding member of the HSBC Group – one of the world's largest banking and financial services organisations – and its flagship in the Asia-Pacific region. It is the largest bank incorporated in the Hong Kong Special Administrative Region and one of the SAR'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 through some 600 branches and offices in 20 countries and territories in Asia-Pacific – the largest network of any international financial institution in the region – and some 20 branches and offices in five other countries around the world. Employing some 54,000 people, of whom 40,700 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2006 of HK$3,151 billion.

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 10,000 offices in 82 countries and territories and assets of US$1,861 billion.

The Hongkong and Shanghai Banking Corporation Limited
Incorporated in the Hong Kong SAR with limited liability
Registered Office and Head Office: HSBC Main Building, 1 Queen's Road Central, Hong Kong
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Report of the Directors

Board of Directors

Vincent Cheng Hoi Chuen, GBS, OBE, *Chairman*
Dr William Fung Kwok Lun, OBE, *Deputy Chairman*
Laura Cha May Lung, SBS, *Deputy Chairman*
(appointed Deputy Chairman on 2 March 2007)
Michael R P Smith, OBE, *President and Chief Executive Officer*
Dr Raymond Ch'ien Kuo Fung, GBS, CBE
Michael F Geoghegan, CBE *(appointed on 1 June 2006)*
Stephen K Green
Stuart T Gulliver *(appointed on 22 September 2006)*
Victor Li Tzar Kuoi
Dr Lo Ka Shui, GBS
Zia Mody *(appointed on 12 January 2006)*
Raymond Or Ching Fai
Christopher D Pratt
(appointed on 27 February 2006)
Jack So Chak Kwong
T Brian Stevenson, SBS
Dr Patrick Wang Shui Chung
Peter Wong Tung Shun
Dr Rosanna Wong Yick-ming, DBE
Marjorie Yang Mun Tak

Principal Activities

The Hongkong and Shanghai Banking Corporation Limited ("the Bank") and its subsidiary and associated companies ("the group") 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 21 to 156.

Reserves

Profits attributable to shareholders, before dividends, of HK$37,709 million have been transferred to reserves. During the year, a surplus of HK$1,356 million, net of the related deferred taxation effect, arising from professional valuations of premises and investment properties held by the Bank and the group was credited to reserves. Details of the movements in reserves, including appropriations therefrom, are set out in note 37 to the financial statements. The Directors do not recommend the payment of a final dividend.

Share Capital

The capital has been increased during the year by US$550 million (HK$4,277 million) by the issue of 550 million Cumulative Redeemable Preference Shares of US$1.00 each. The shares were issued in order to maintain the capital ratio at an appropriate level, and to support business growth. In accordance with Hong Kong Accounting Standard 32, Financial Instruments – Disclosure and Presentation, these Preference Shares are presented as liabilities in the consolidated balance sheet and the balance sheet of the Bank. Details of the movements in share capital of the Bank during the year are set out in notes 35 and 36 to the financial statements.

Directors

The names of the Directors serving during the year and up to the date of this report are set out above, apart from Sir John Bond who retired on 23 May 2006.

Directors' Interests in Contracts

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

Certain Directors of the Bank 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 Savings-Related Share Option Plan, the HSBC Holdings Restricted Share Plan 2000 and The HSBC Share Plan. During the year, Sir John Bond, V H C Cheng, M F Geoghegan, S K Green, S T Gulliver, R C F Or, M R P Smith and P T S Wong acquired shares in HSBC Holdings plc under the terms of the Restricted Share Plan. M F Geoghegan and M R P Smith also acquired shares by exercising options.

Apart from these arrangements, at no time during the year was the Bank, its holding companies, its subsidiary companies or any fellow subsidiary company a party to any arrangements to enable the Directors of the Bank 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. The current members of the Committee are M R P Smith (Chairman of the Committee), Vincent Cheng Hoi Chuen, Raymond Or Ching Fai, Peter Wong Tung Shun (Directors), J W Addis (Chief Operating Officer), E D Ancona (Chief Financial Officer), R H Cox (Head of Corporate, Investment Banking and Markets), C Engel (Regional Director, Personal Financial Services), B G Fredrick (Head of International), Margaret Leung Ko May Yee (General Manager, Global Co-Head Commercial Banking), C R Page (Chief Credit Officer), E I Sinyak (Chief Information Officer) and R S Tait (Head of Human Resources).

Audit Committee

An Audit Committee, comprising three non-executive Directors of the Bank, 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 and compliance. The members of the Audit Committee are T B Stevenson (Chairman of the Committee), Dr Lo Ka Shui and Dr Patrick Wang Shui Chung.

Donations

Donations made by the Bank and its subsidiary companies during the year amounted to HK$68 million.

Hong Kong Monetary Authority Guidelines on Financial Disclosure and Corporate Governance

The Directors are of the view that the Accounts for the year ended 31 December 2006 fully comply with the Hong Kong Monetary Authority Guidelines on Financial Disclosure by, and Corporate Governance of, Locally Incorporated Authorised Institutions.

Auditors

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

On behalf of the Board
V H C Cheng, *Chairman*
Hong Kong, 5 March 2007

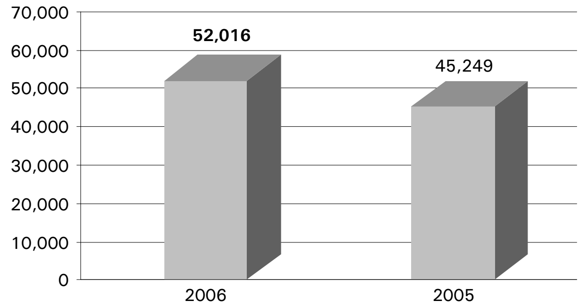
Financial Review

Summary of Financial Performance

Group Profit

Profit attributable to shareholders for 2006 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiary and associated companies ('the group') increased by HK$4,836 million, or 14.7 per cent, to HK$37,709 million in 2006. Profit before taxation increased by HK$6,767 million, or 15.0 per cent, to HK$52,016 million.

Profit before tax (HK$ millions)



Economic Profit

The group's internal performance measures include economic profit, a calculation which compares the return on the financial capital invested in the group by its immediate holding company with the cost of that capital. The group prices its cost of capital internally and the difference between that cost and post-tax profit attributable to the ordinary shareholders represents the amount of economic profit generated. Economic profit is used by management as a means of deciding where to allocate resources so that they will be most productive. For this purpose, the cost of capital is currently estimated to be 9.1 per cent in 2006 (2005: 8.5 per cent).

(HK$ millions)	2006	2005
Average invested capital	**163,388**	138,778
Return on invested capital*	**42,322**	34,991
Cost of capital	**(14,802)**	(11,810)
Economic profit	**27,520**	23,181

* *Return on invested capital represents attributable profit adjusted for non-cash items.*

Customer Groups

The group comprises five major customer groups. Personal Financial Services provides financial services to individuals, including self employed individuals (but excluding individuals managed by Private Banking). Commercial Banking manages relationships with small and medium sized corporates. Corporate, Investment Banking and Markets includes the relationships with large corporate and institutional customers together with the group's treasury and investment banking operations. Private Banking provides financial services to high net worth individuals, who have complex financial affairs. Due to the nature of the HSBC Group structure, the majority of HSBC's Private Banking business in Hong Kong and the rest of Asia-Pacific is not included within The Hongkong and Shanghai Banking Corporation group. Other mainly represents investments in premises, investment properties and shareholders' funds to the extent that they have not been allocated to the other business segments. In addition, a number of income and expense items include the effect of financial transactions entered into in the ordinary course of business between customer groups. The analysis below includes inter-segment amounts within each customer group with the elimination shown in a separate column.

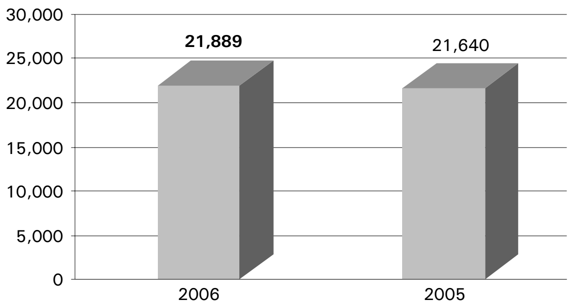
Personal Financial Services reported profit before tax of HK$21,889 million, an increase of 1.2 per cent over 2005 as strong growth in operating income of 15.9 per cent was offset by higher credit card impairment allowances in Taiwan and Indonesia, and investment expenditure in the rest of Asia-Pacific.

Overall, net interest income increased by HK$3,289 million, or 12.3 per cent, compared with 2005. In Hong Kong, net interest income rose by HK$2,029 million, or 10.0 per cent, as effective management of deposit pricing amid the continued trend of rising interest rates resulted in a further widening of liability spreads. Average customer account balances rose by 7.1 per cent, reflecting successful promotional campaigns and customer preference for maintaining liquidity in order to take advantage of short-term investment opportunities. The local mortgage market remained highly competitive as sales volumes in the housing market slowed and margins were impacted by a higher cost of funds and competitor price promotions. However, HSBC regained leadership in market share of new business, largely as a result of a simplified pricing campaign launched by the bank in Hong Kong in the first quarter of 2006. Credit card lending grew, but net interest income fell as the benefit of higher receivables was more than offset by a rise in funding costs.

In the rest of Asia-Pacific, net interest income rose by HK$1,260 million, or 19.6 per cent, reflecting strong balance sheet growth across the region. The deposit base expanded in a number of countries, particularly Singapore, Indonesia and mainland China, reflecting evolution of the focused strategy on HSBC *Premier* customers, and deposit spreads improved on the back of higher interest rates. Income from mortgages increased as lending grew, notably in Singapore and Taiwan, led by competitive pricing and increased marketing activity. Interest earned on credit cards was higher in the Philippines, Indonesia and India, reflecting growth in receivables, but spreads narrowed in the face of increased funding costs. Credit card interest income fell significantly in Taiwan as lending was reduced following the introduction of a government debt renegotiation scheme with zero or low rates. Income from personal instalment loans rose, notably in India, Korea and Indonesia, following the successful launch of these products in mid-2005.

Personal Financial Services

Profit before tax (HK$ millions)



Net fee income of HK$10,512 million was 30.6 per cent higher than in 2005, driven by buoyant regional and global stock markets and greater demand for wealth management products. In Hong Kong, fee income was up by HK$1,828 million, or 31.7 per cent. Fee income from stockbroking and custody services rose by 80.3 per cent, reflecting higher stock market transaction volumes. Sales of unit trusts increased significantly as investors switched to equity-related products, encouraged by improved markets and the launch of new investment funds. In the rest of Asia-Pacific, fee income rose by 27.7 per cent on the back of strong demand for investment products in Korea, Taiwan, India and Singapore, with revenue from wealth management sales in the region increasing by HK$355 million, or 33.8 per cent.

Fee income from credit cards was HK$671 million, or 29.1 per cent, higher than in 2005 as the group strengthened its position as the largest card issuer in Hong Kong, with over 4.6 million cards in force. In the rest of Asia-Pacific, particularly India and the Philippines, expansion of the cards business continued. This was supported by extensive marketing campaigns and sales efforts, resulting in a rise of 21.3 per cent in the number of cards to a total of 5.7 million issued, and a 19.3 per cent increase in cardholder spending.

Insurance income rose by 13.0 per cent, with continued focus on the development of the group's retirement planning proposition and was supported by increased levels of marketing activity and distribution channel development. Sales of other life assurance products also grew and revenue from general insurance, particularly medical, travel and home insurance, increased.

Gains from financial investments principally comprise profit realised from the partial disposal of shares held in MasterCard Inc.

Other operating income increased by HK$278 million, attributable to gains on the sale of the Australian stockbroking, margin lending and broker-originated mortgage businesses, and the share of profit attributable to Personal Financial Services from the transfer of the credit card merchant acquiring business to a joint venture company set up with Global Payments Inc. These gains were partially offset by lower IT cost recoveries in Hong Kong from other regional group entities resulting from a change in the charging methodology across customer groups.

The charge for loan impairment increased by HK$3,184 million to HK$4,528 million, largely attributable to higher credit card delinquency levels in Taiwan and Indonesia. Delinquency rates and write-offs rose in Taiwan largely as a result of government measures to control consumer credit growth. Indonesia has been affected by higher minimum repayment rules, coupled with a hefty reduction in the government subsidy of fuel prices. Volume growth in credit card receivables in Hong Kong and in personal instalment loans in other parts of the region also contributed to the increased charge, whereas the prior period benefited from non-recurring releases of provisions against mortgage lending and restructured facilities in Hong Kong.

Operating expenses were HK$2,981 million, or 17.6 per cent, higher than in 2005, principally driven by continued investment to develop and expand the business in the rest of the Asia-Pacific region. In Hong Kong, operating expenses rose by 10.6 per cent, largely

Financial Review (continued)

Customer Groups *(continued)*

in relation to major credit card marketing campaigns and headcount growth in customer-facing roles. Staff recruitment increased to support the introduction in September 2006 of the five-day working week and extended opening hours, and payroll costs further rose due to higher performance-related bonuses and annual salary increments. Technology costs were also higher, reflecting investment in customer portfolio management systems and the enhancement of distribution channel capabilities. In the rest of Asia-Pacific, costs increased by HK$1,936 million, or 27.4 per cent, notably in India and Korea, as the group continued to pursue organic growth in the region. Headcount rose by 29.1 per cent as sales and support functions were expanded, and premises costs rose as new branches were opened in mainland China and a number of other countries. Higher marketing costs were incurred to drive sales and promote the HSBC brand, with specific campaigns targeted to increase customer numbers and raise market share in credit cards, mortgages and personal loans, and to attract new deposits. In addition, costs were incurred in the start-up of the consumer finance business in the region, particularly in India, Australia and Indonesia, and in relation to the launch of HSBC Direct in Taiwan and Korea in September 2006 and February 2007 respectively.

Income from associates of HK$257 million includes improved results from Bank of Communications and Industrial Bank.

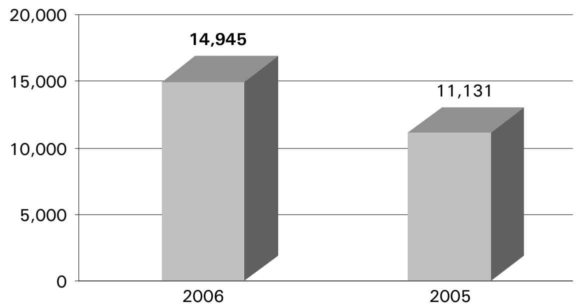
Commercial Banking reported profit before tax of HK$14,945 million, an increase of 34.3 per cent over 2005, driven by improved deposit spreads and balance sheet growth.

Net interest income increased by HK$2,917 million, or 26.3 per cent, compared with 2005. This reflected growth in average deposits and advances as well as improvements in deposit spreads following further rises in interest rates across the region this year. In Hong Kong, net interest income rose by HK$1,916 million, or 22.5 per cent, due to growth in liability balances, reflecting the active promotion of the 'BusinessVantage' account in Hong Kong and the widening of deposit spreads. Strong demand for credit continued in the property sector and from manufacturers with operations on the Mainland, but lending margins were compressed due to keen market competition and higher funding costs. Emphasis on the small business segment was strengthened with the opening of dedicated small business banking centres, more relationship managers and sales staff, and the launch of a streamlined lending process. Cross-border relationships continued to be an area of emphasis, and the regional alignment proposition was enhanced to capture business flows between Hong Kong, mainland China, Taiwan and Vietnam, which led to a significant increase in inter-office referrals.

In the rest of Asia-Pacific, net interest income grew by 39.0 per cent. Liability spreads improved across the region and the deposit base expanded in various countries, particularly in Taiwan, Singapore and India, following successful marketing campaigns and sales incentives. Account balances in India increased also due to the receipt of IPO funds. In addition, the offshore business in Mauritius performed well. Term lending and trade finance increased, notably in mainland China, India, Korea and Australia as a result of promotional activities, enhanced packaged lending propositions, together with expansion of the branch network and internet banking. Asset spreads also improved.

Commercial Banking

Profit before tax (HK$ millions)



Net fee income rose by HK$494 million, or 10.9 per cent, largely attributable to higher fees from account services and remittances, particularly in Hong Kong as a result of enhancements to the product range and increased cross-border remittances. Credit card merchant acquiring fees dropped by 11.5 per cent as the majority of the business was transferred in July 2006 to a joint venture company set up with Global Payments Inc. Fees from trade services were higher with increases in mainland China, India, Bangladesh and Indonesia partially offset by lower revenues in Hong Kong due to intense market competition. Buoyant local equity markets and the launch of new investment products contributed to increased wealth management sales in Hong Kong. Income from sales of foreign exchange and interest rate derivative products increased by 24.8 per cent, benefiting from an increase in hedging transactions and cross-border payments.

Insurance revenues, particularly from life insurance products, continued to grow following the establishment of a dedicated commercial banking insurance division last year. Income increased by 71.2 per cent. Fees from the Mandatory Provident Fund business in Hong Kong also grew strongly.

Other operating income increased by HK$53 million, due to the share of profit attributable to Commercial Banking from the transfer of the credit card merchant acquiring business to a joint venture company set up with Global Payments Inc.

The charge for loan impairment was HK$450 million lower than in 2005, reflecting a decrease in new specific provisions in Hong Kong, although releases in Hong Kong, mainland China, India and Singapore were also lower. Credit quality generally remained stable.

Operating expenses increased by 20.4 per cent over 2005. The number of sales and back-office staff rose in support of SME initiatives, insurance business expansion, product development and increased branch presence, and expenditure rose on marketing campaigns to win new business and raise market penetration. Ongoing investment in the development and promotion of internet banking and other lower-cost delivery channels resulted in higher IT and infrastructure costs. Business Internet Banking in Hong Kong continued to show impressive growth and was enhanced to support sales of unit trusts and structured deposits. User numbers increased by over 20 per cent and the proportion of online transactions grew by 42.2 per cent. Staff costs and marketing expenditure rose in Korea and mainland China in order to further develop the group's commercial banking business in these countries.

Income from associates was HK$544 million higher than in the prior year and includes improved results from Bank of Communications and Industrial Bank.

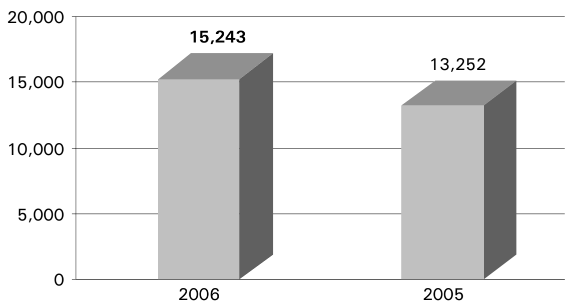
Corporate, Investment Banking and Markets reported profit before tax of HK$15,243 million, 15.0 per cent higher than 2005, attributable to an excellent performance in Global Transaction Banking and strong trading profits in Global Markets.

Net interest income increased by HK$379 million, or 4.3 per cent, compared with 2005. In Global Markets, balance sheet management revenues declined as the cost of funding fixed rate asset positions, put on in earlier periods, rose significantly, although these asset positions had, however, largely run off by the end of the first half of 2006. In addition, flat yield curves made it difficult to generate income through position-taking. Net interest income in Global Transaction Banking increased by 62.7 per cent, notably in India, Hong Kong, Singapore, Taiwan, mainland China and Korea as a result of business growth and interest rate rises in the region. Deposit balances grew by 22.3 per cent as the payments and cash management business successfully completed the implementation of a record number of domestic and cross-border cash management mandates. The securities services business performed well, particularly in India, Taiwan and Korea. Trade finance revenues grew, notably in Japan and Korea. Net interest income from corporate lending fell by 4.7 per cent as the benefit of balance sheet growth in Hong Kong was offset by competitive pressures on spreads. Strong growth in advances to corporates in mainland China was achieved, reflecting investment made in expanding customer relationships and inflow of business into the group's new branches on the Mainland.

Net fee income increased by HK$1,549 million, or 28.7 per cent. In Global Transaction Banking, fees rose by HK$1,294 million, or 34.2 per cent. The securities services business continued to broaden capabilities across the region, and was strengthened by the acquisition of the sub-custody business in Australia and New Zealand from Westpac. Volumes benefited from buoyant local stock markets, particularly in Hong Kong, Korea and India. Fee income from the asset management business increased by 48.1 per cent, reflecting higher fund advisory and distribution fees and growth in funds under management. Investment banking revenues were higher as the division arranged a number of structured finance transactions in Hong Kong, but underwriting income declined although several mandates for mid-tier IPOs were won.

Corporate, Investment Banking and Markets

Profit before tax (HK$ millions)



Net trading income rose by 20.3 per cent to HK$8,682 million. Foreign exchange and interest rate derivatives revenues were higher as currency volatility provided good trading opportunities, particularly in regional currencies, and customer volumes increased reflecting HSBC's focus on capturing emerging market flows from heightened client interest in emerging markets, particularly in India and mainland China. Strong results were achieved from equities and equity derivatives trading, reflecting business expansion in these areas and buoyant regional stock markets. Private equity

Financial Review (continued)

Customer Groups *(continued)*

investments also performed strongly. Tighter credit spreads in the corporate bond market created fewer trading opportunities compared to previous years, and there was a reduced contribution from the structured interest rate derivatives business as investors focused on shorter-dated interest rate products and other asset classes.

Gains on the disposal of financial investments were HK$207 million higher than in 2005 and largely comprised profits made on the sale of Philippine government securities in 2006, together with the non-recurrence of losses on disposals of securities sold in 2005, following strategic decisions to reduce interest rate risk in certain portfolios.

There was a net release of loan impairment provisions of HK$250 million, compared with a release of HK$165 million in 2005, as the corporate credit environment throughout the region remained benign.

Operating expenses increased by 16.4 per cent compared with 2005, reflecting headcount increases and IT investment to support business expansion in all areas and higher performance-related remuneration in the investment banking division and in Global Markets. The transfer to the group of HSBC Securities Japan from another HSBC Group company in the second quarter of 2005 also contributed to the increase in expenses as a full period of costs was reflected this year.

Income from associates of HK$671 million includes improved results from Bank of Communications and Industrial Bank.

Other includes income and expenses relating to certain funding, investment, property and other activities that are not allocated to other customer groups. Gains from financial investments largely comprise profit on the disposal of part of the group's stake in UTI Bank, and other operating income includes profits made on property sales. These gains were partially offset by lower revaluation gains on investment property.

(HK$ millions)	Personal Financial Services	Commercial Banking	Corporate, Investment Banking and Markets	Private Banking	Other	Intra-segment elimination	Total
2006							
Net interest income/(expense)	30,090	14,006	9,104	45	(4,201)	2,055	51,099
Net fee income/(expense)	10,512	5,018	6,937	101	(164)	–	22,404
Net trading income	889	796	8,682	14	825	(2,288)	8,918
Net income/(loss) from financial instruments designated at fair value	3,364	(384)	74	(1)	(616)	233	2,670
Gains less losses from financial investments	108	–	226	–	1,132	–	1,466
Dividend income	9	10	55	–	675	–	749
Net earned insurance premiums	20,741	972	133	–	–	–	21,846
Other operating income	2,262	348	430	14	7,005	(4,406)	5,653
Total operating income	67,975	20,766	25,641	173	4,656	(4,406)	114,805
Net insurance claims incurred and movement in policyholders' liabilities	(21,902)	(478)	(100)	–	–	–	(22,480)
Net operating income before loan impairment charges and other credit risk provisions	46,073	20,288	25,541	173	4,656	(4,406)	92,325
Loan impairment charges and other credit risk provisions	(4,528)	(446)	250	–	(85)	–	(4,809)
Net operating income	41,545	19,842	25,791	173	4,571	(4,406)	87,516
Operating expenses	(19,913)	(6,531)	(11,219)	(167)	(4,815)	4,406	(38,239)
Operating profit/(loss)	21,632	13,311	14,572	6	(244)	–	49,277
Share of profit in associates and joint venture	257	1,634	671	–	177	–	2,739
Profit/(loss) before tax	21,889	14,945	15,243	6	(67)	–	52,016

Customer Groups *(continued)*

(HK$ millions)	Personal Financial Services	Commercial Banking	Corporate, Investment Banking and Markets	Private Banking	Other	Intra-segment elimination	Total
2005							
Net interest income/(expense)	26,801	11,089	8,725	63	(3,800)	613	43,491
Net fee income	8,050	4,524	5,388	55	80	–	18,097
Net trading income/(loss)	683	638	7,215	10	(582)	(784)	7,180
Net income/(loss) from financial instruments designated at fair value	666	(648)	122	–	73	171	384
Gains less losses from financial investments	–	23	19	–	714	–	756
Dividend income	5	14	167	–	182	–	368
Net earned insurance premiums	18,437	756	147	–	–	–	19,340
Other operating income	1,984	295	572	13	6,338	(4,305)	4,897
Total operating income	56,626	16,691	22,355	141	3,005	(4,305)	94,513
Net insurance claims incurred and movement in policyholders' liabilities	(16,889)	(330)	(72)	–	–	–	(17,291)
Net operating income before loan impairment charges and other credit risk provisions	39,737	16,361	22,283	141	3,005	(4,305)	77,222
Loan impairment charges and other credit risk provisions	(1,344)	(896)	165	–	11	–	(2,064)
Net operating income	38,393	15,465	22,448	141	3,016	(4,305)	75,158
Operating expenses	(16,932)	(5,424)	(9,642)	(113)	(4,008)	4,305	(31,814)
Operating profit/(loss)	21,461	10,041	12,806	28	(992)	–	43,344
Share of profit in associates and joint venture	179	1,090	446	–	190	–	1,905
Profit/(loss) before tax	21,640	11,131	13,252	28	(802)	–	45,249

Net Interest Income

Net interest income of HK$51,099 million was HK$7,608 million, or 17.5 per cent, higher than in 2005. The contribution from balance sheet growth and improved deposit spreads throughout the region was partially offset by significantly lower balance sheet management income.

Net interest income in Personal Financial Services rose by HK$3,289 million, or 12.3 per cent, partly due to improved liability spreads earned in the higher interest rate environment, coupled with strong growth in the deposit base. Lending growth also contributed to the increase in interest income, particularly personal loans in India and Korea, credit cards in the Philippines, India and Indonesia, and mortgages in Singapore, Taiwan and at Hang Seng Bank. In addition, strong returns were also generated on investments held by the group's insurance companies, benefiting from higher yields and growth in portfolio size. Net interest income in Commercial Banking was HK$2,917 million, or 26.3 per cent, ahead of the prior period due to balance sheet growth, notably in Hong Kong, India, Singapore and mainland China, and improved deposit spreads. In Corporate, Investment Banking and Markets, net interest income from Global Transaction Banking increased significantly, due to higher deposit balances and spreads, notably in Hong Kong and India. Global Markets saw a decline in balance sheet management revenues, which were impacted by higher funding costs and flat yield curves.

Financial Review (continued)

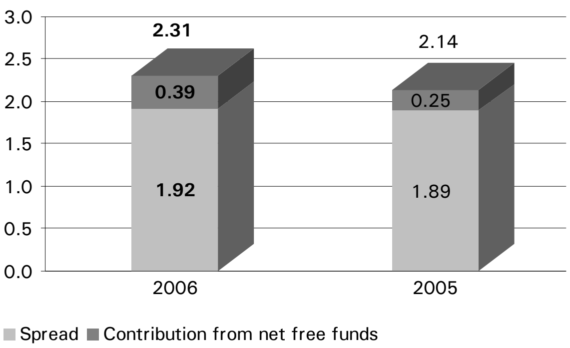
Net Interest Income *(continued)*

Average interest-earning assets rose by HK$181.2 billion, or 8.9 per cent, to HK$2,212.5 billion. Average advances to customers grew by HK$82.4 billion, or 8.5 per cent, with strong increases in corporate loans in Hong Kong, India, mainland China and Australia, and rises in mortgage lending in Hong Kong, Singapore, Korea, Taiwan and India. Average credit card balances rose in all areas, notably Hong Kong, the Philippines, Indonesia and India, and personal instalment loans grew, most significantly in Korea. Average placements with banks were HK$56.2 billion higher, and holdings of financial investments rose by HK$43.4 billion, reflecting the deployment of the commercial surplus.

(HK$ millions)	2006	2005
Average interest-earning assets	2,212,521	2,031,314

The group's net interest margin of 2.31 per cent for 2006 was 17 basis points higher than in 2005. The reduction in balance sheet management income negatively affected margin by 11 basis points when compared to 2005. However, net interest spread improved by three basis points overall, attributable to tactical deposit pricing. The contribution from net free funds increased by 14 basis points reflecting higher interest rates and an increase in free funds from retained earnings and trading book structured deposits, although other net trading liabilities decreased.

Net interest margin (%)



For the bank in Hong Kong, net interest margin increased by nine basis points to 2.26 per cent for 2006. Spread rose by three basis points, benefiting from higher interest rates. Spreads on Hong Kong dollar and foreign currency current accounts and savings accounts improved as the value of funds rose, whilst increases in interest rates paid to customers were contained. This was partly offset by the negative impact of lower balance sheet management income as fixed rate asset positions faced an increase in funding costs. Spreads on mortgages and credit cards were also affected by a higher cost of funds, and competitive pressures on pricing affected corporate lending margins. The contribution from net free funds increased by six basis points due to the increase in market interest rates.

At Hang Seng Bank, net interest margin improved by 23 basis points as the increase in contribution from net free funds outweighed the fall in spread. Net interest spread declined by 11 basis points as returns on treasury balance sheet management portfolios were affected by rising funding costs and flat yield curves, and spreads narrowed on mortgages and corporate loans due to competitive pressures on pricing. These outweighed the favourable impact of the growth in advances and a wider spread between the bank's best lending rate ('BLR') and HIBOR. The contribution from net free funds increased by 34 basis points, benefiting from the rise in market interest rates and from higher balances of structured deposits which are classified as trading liabilities, the related interest expense being included within 'Net trading income'.

Net interest margin (%)

	2006	2005
Hong Kong:		
The bank	2.26	2.17
Hang Seng Bank	2.42	2.19
Rest of Asia-Pacific	2.16	2.00

In the rest of Asia-Pacific, net interest margin at 2.16 per cent was 16 basis points higher than in 2005. Spread increased by nine basis points to 1.94 per cent. All major sites faced an increase in funding costs due to higher interest rates across the region, but spreads rose in several countries, notably in India due to an increase in higher-yielding personal loans and credit cards and a rise in low cost current account balances from custody and clearing customers. Margins also rose in mainland China from higher spreads on corporate lending as deposit rate rises lagged lending rate increases, in Singapore due to rises in mortgage lending rates, and in Australia from higher yields on corporate bonds. These increases were partially offset by lower spreads on credit card advances in Taiwan and competitive pressures on mortgage lending rates in Korea. The contribution from net free funds rose by seven basis points, benefiting from higher market interest rates.

Net Fee Income

Net fee income was HK$4,307 million, or 23.8 per cent, higher than in 2005. Securities broking and custody fees rose by 54.8 per cent, reflecting higher stock market turnover in Hong Kong and the region, with increases from both personal and corporate customers. The buoyant equity markets also stimulated customer demand for unit trusts and structured products. Funds under management and related fees increased, in part due to institutional business transferred from another HSBC Group entity in the second quarter of 2005. Fee income also includes significant fund advisory and performance fees, reflecting the success of certain emerging markets funds. Trade finance income and remittance and other account fees grew, reflecting the group's strong transactional capabilities. Hong Kong Mandatory Provident Fund management fees increased by 33.8 per cent due to new business and improved investment performance. Gross fee income from credit cards was impacted by a loss of revenues in Taiwan as credit card activity fell in the wake of the country's curbs on consumer credit growth, and due to the transfer of the majority of the merchant acquiring business to a joint venture company set up with Global Payments Inc. However, there was strong growth elsewhere in the region due to an increase in the number of cards in circulation and higher cardholder spending. 'Other' fees include an increase in sales credits received from fellow HSBC group companies in respect of treasury business.

Fee expense rose due to increased brokerage fees paid by Global Markets on account of higher trading activity, and higher investment management advisory fees paid to another HSBC Group company.

(HK$ millions)	2006	2005
Account services	**1,501**	1,314
Credit facilities	**1,245**	1,159
Import/export	**2,956**	2,777
Remittances	**1,437**	1,248
Securities/stockbroking	**5,267**	3,402
Cards	**4,335**	4,231
Insurance	**315**	280
Unit trusts	**2,326**	1,627
Funds under management	**2,974**	2,233
Other	**4,198**	3,400
Fee income	**26,554**	21,671
Fee expense	**(4,150)**	(3,574)
Net fee income	**22,404**	18,097

Net Trading Income

Trading income rose by 24.2 per cent to HK$8,918 million. Foreign exchange profits benefited from an increase in trading activity against a backdrop of increasing demand for local currency assets as foreign investors sought to participate in local stock markets, coupled with favourable positioning as the US dollar weakened. Revenues grew strongly in the equities and equity derivatives business, reflecting business expansion and buoyant stock markets. Strong gains were also made on the revaluation of private equity investments. However, the contribution from structured derivatives trading declined, and the rising interest rate environment negatively impacted corporate bond trading revenues. Net interest expense decreased due to higher interest income from increased holdings of trading assets, but was largely offset by a rise in interest expense from the increase in structured deposit products issued to retail customers.

(HK$ millions)	2006	2005
Dealing profits	**10,001**	8,560
Gain/(loss) from hedging activities	**16**	(1)
Net interest expense	**(1,307)**	(1,484)
Dividend income from trading securities	**208**	105
Net trading income	**8,918**	7,180

Financial Review (continued)

Gains Less Losses from Financial Investments

The profit on the disposal of available-for-sale securities largely comprises the gain on the disposal of part of the group's stake in UTI Bank, reducing the group's interest to 4.99 per cent. Profits were also made on the sale of Philippine government securities and other operational investments.

(HK$ millions)	2006	2005
Profit on disposal of available-for-sale securities	1,466	762
Other	–	(6)
Gains less losses from financial investments	1,466	756

Insurance Income

Premium income rose by HK$2,506 million, or 13.0 per cent, over 2005, primarily attributable to growth in the life assurance business in Hong Kong. The product range was expanded with the launch of new retirement and other investment-linked products. Investment income was higher, reflecting the growing portfolio size, higher interest yields and improved equity returns. Fee income rose due to the increased portfolio size and improved investment performance of the Hong Kong Mandatory Provident Fund business. The movement in the present value of in-force business fell, despite a rise in premium income, due to a change in product mix which comprised an increase in shorter-term policies. Claims and movement in policyholders' liabilities comprise returns owed to investment policyholders as well as general insurance claims. The increase is largely in line with the rise in premium income and investment income.

The following table shows the revenues included in the consolidated income statement earned by the group's insurance businesses:

(HK$ millions)	2006	2005
Net interest income	2,328	1,715
Net fee income	636	484
Net income from financial instruments designated at fair value	2,980	16
Gains less losses from financial investments	29	53
Dividend income	1	2
Net earned insurance premiums	21,846	19,340
Movement in present value of in-force business	1,124	1,185
Other operating income	72	90
	29,016	22,885
Net insurance claims incurred and movement in policyholders' liabilities	(22,480)	(17,291)
Net operating income	6,536	5,594

Other Operating Income

Other operating income for 2006 included gains on the disposal of the stockbroking, margin lending and broker originated mortgage businesses in Australia, a gain on the transfer of the credit card merchant acquiring business to a joint venture company set up with Global Payments Inc., and profits on the sale of property in Hong Kong and Japan.

Gains on investment properties comprise unrealised revaluation gains, together with realised profits on disposals. Gains were lower than in 2005 as valuations were affected by a slowdown in property price rises in Hong Kong.

The surplus arising on property revaluation represents reversals of prior year revaluation deficits that had arisen when the value of certain premises fell below depreciated historical cost. This was lower than in 2005 as the number of properties with revaluation deficits decreased.

'Other' largely comprises recoveries from fellow HSBC group companies of IT and other operating costs incurred on their behalf.

(HK$ millions)	2006	2005
Rental income from investment properties	196	215
Movement in present value of in-force insurance business	1,124	1,185
Gains on investment properties	475	1,167
Profit on disposal of property, plant and equipment, and assets held for sale	981	111
Profit on disposal of subsidiaries, associates and business portfolios	904	53
Surplus arising on property revaluation	70	370
Other	1,903	1,796
Other operating income	5,653	4,897

Loan Impairment Charges and Other Credit Risk Provisions

The net charge for loan impairment and other credit risk provisions was HK$2,745 million higher than in 2005. The environment for corporate credit remained stable in contrast to more difficult credit conditions for personal lending in some parts of the region.

The charge for new individually assessed allowances was lower, attributable to a decrease in charges against corporate lending, as the prior period included a significant one-time charge. Releases and recoveries were also lower, largely relating to corporates in Hong Kong and the region, and against mortgage lending in Hong Kong.

The net charge for collectively assessed allowances rose significantly, due to higher charges against credit card lending, most notably in Taiwan and Indonesia. Delinquency rates and write-offs rose in Taiwan largely as a result of government measures to curb excessive consumer credit growth. These included increasing the minimum monthly repayment amount, while at the same time introducing a debt renegotiation scheme which offers extended repayment periods at substantially reduced rates. Indonesia was also affected by higher minimum repayment rules, coupled with rises in inflation largely as a result of the reduction of government fuel price subsidies. Elsewhere, volume growth in credit cards and other personal lending, coupled with the non-recurrence of releases in 2005, also contributed to the increase.

Other credit risk provisions include an impairment charge against an available-for-sale equity investment in Taiwan.

Net charge/(release) for impairment provisions by region (HK$ millions)

	2006	2005
Hong Kong	**1,228**	1,156
Rest of Asia-Pacific	**3,473**	924
Americas/Europe	**–**	(12)
Total	**4,701**	2,068

Net charge/(release) for impairment and other credit risk provisions (HK$ millions)

	2006	2005
Net charge for impairment of customer advances		
– Individually assessed impairment allowances:		
New allowances	**1,314**	2,129
Releases	**(869)**	(1,755)
Recoveries	**(212)**	(267)
	233	107
– Net charge for collectively assessed impairment allowances	**4,468**	1,961
	4,701	2,068
Net charge/(release) of other credit risk provisions	**108**	(4)
Net charge for loan impairment and other credit risk provisions	**4,809**	2,064

Operating Expenses

Staff costs increased by HK$3,306 million, or 18.6 per cent, compared with 2005. Salaries rose by 16.2 per cent, reflecting increased headcount and annual salary increments. Staff numbers rose in Hong Kong in support of the implementation of the five-day working week and extended weekend opening hours. In the rest of Asia-Pacific region, headcount grew in support of new branch openings, establishment of the consumer finance business, and expansion of the sales force and call centres. Ownership of the group service centre in Guangdong was transferred to another HSBC Group entity with a resultant decrease in headcount of around 3,500 in the rest of Asia-Pacific region. Performance-related pay in Hong Kong and the rest of Asia-Pacific increased in line with improved operating revenues, higher dealing income and the increase in headcount.

Financial Review (continued)

Operating Expenses *(continued)*

Staff numbers by region*

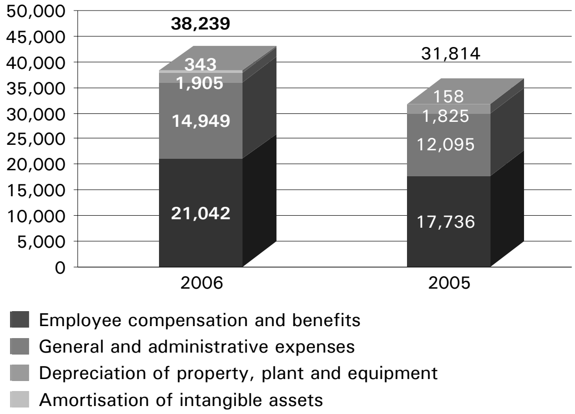
	2006	2005
Hong Kong:		
The bank and wholly owned subsidiaries	**18,032**	16,997
Hang Seng Bank	**8,464**	7,845
Total Hong Kong	**26,496**	24,842
Rest of Asia-Pacific:		
Australia	**1,355**	1,374
Mainland China	**3,732**	6,631
India	**6,064**	4,509
Indonesia	**2,744**	1,980
Singapore	**2,312**	2,121
Taiwan	**2,392**	2,143
Others	**8,919**	7,198
Total rest of Asia-Pacific	**27,518**	25,956
Americas/Europe	**17**	18
Total	**54,031**	50,816

* *Full time equivalent*

The increase in general and administrative expenses of HK$2,854 million, or 23.6 per cent, reflected additional costs incurred in business expansion throughout the region. Premises costs rose due to new branch openings, expansion of office space and rent increases. Advertising and marketing expenditure was higher, notably in Hong Kong, India, Korea and mainland China, and comprised specific product campaigns, particularly in Personal Financial Services, and other drives to increase brand awareness. Technology costs also increased as the group continued to invest in enhanced channel capabilities and improved portfolio management systems.

	2006	2005
Cost efficiency ratio (%)	**41.4**	41.2

Operating expenses (HK$ millions)



Share of Profit in Associates and Joint Venture

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

(HK$ millions)	**2006**	2005
Share of profit in associates and joint venture	**2,739**	1,905

Tax Expense

The effective rate of tax for 2006 was 18.1 per cent compared with 17.8 per cent in 2005. The increase was attributable to a higher proportion of the group's taxable profits being generated in higher tax rate jurisdictions, particularly India, Japan and Australia.

	2006	2005
Effective rate of tax (%)	**18.1**	17.8

Assets

Total assets increased by HK$478.3 billion, or 17.9 per cent, since 31 December 2005.

Cash and short-term funds increased by HK$15.3 billion, or 3.0 per cent, and placings with banks maturing after one month increased by HK$34.5 billion, or 49.6 per cent, notably in Hong Kong and Singapore, attributable to deployment of part of the commercial surplus into inter-bank placements.

Trading assets rose by HK$123.1 billion, or 57.1 per cent. Holdings of treasury bills increased, principally in Hong Kong and Japan as surplus funds were deployed into short-term instruments. Trading activity was higher and holdings of government bonds and corporate debt securities rose to take advantage of higher yields.

Net advances to customers increased by HK$44.5 billion, or 4.4 per cent, since the end of 2005.

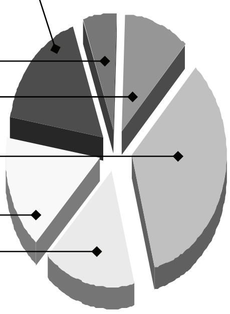
Net advances in Hong Kong rose by HK$10.3 billion, or 1.7 per cent. Mortgage lending increased by 5.1 per cent due to successful campaigns by the bank in Hong Kong and by Hang Seng Bank. This excludes the impact of the fall in lending under the Government Home Ownership Scheme which remained suspended throughout 2006. Credit card and other personal lending rose following extensive marketing activity. Corporate and commercial loan balances decreased, primarily due to the repayment of advances by large corporate customers towards the year end, although advances to smaller businesses in the property and manufacturing sectors grew, boosted by increased demand from manufacturers with operations in mainland China, and trade finance balances increased at Hang Seng Bank.

In the rest of Asia-Pacific, net advances increased by HK$34.1 billion, or 9.0 per cent. The broker-originated mortgage portfolio in Australia was sold in December 2006 and part of the mortgage book in New Zealand was reclassified as held for sale and included within 'Other assets'. Excluding these portfolios, gross advances grew by HK$51.1 billion, or 14.0 per cent, reflecting successful business expansion across the region. Mortgage lending increased by 12.0 per cent, principally in Australia (non-broker business), India and Taiwan. Credit card receivables grew by 20.9 per cent, largely in India, Australia, the Philippines and Thailand, and the consumer finance business expanded following its successful launch in India, Indonesia and Australia. Lending to commercial and corporate customers rose by 12.9 per cent, notably in mainland China, India, Mauritius and Australia, as the group focused on capturing cross-border business and the provision of trade finance.

Financial investments rose by HK$90.3 billion, or 22.9 per cent, reflecting deployment of part of the commercial surplus in Hong Kong into debt securities and treasury bills. Investment portfolios held by the insurance companies grew, due to the increase in new life business. The value of the group's 9.91 per cent investment in Ping An Insurance also rose significantly.

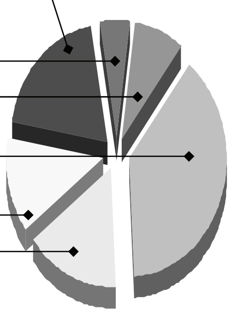
Assets 2006*

	%	HK$ millions
Cash and short-term funds	**17.0**	**518,022**
Placings with banks maturing after one month and certificates of deposit	**5.8**	**177,237**
Trading assets	**11.1**	**338,792**
Advances to customers	**34.3**	**1,043,782**
Financial investments	**15.9**	**484,841**
Other	**15.9**	**485,792**
Total	**100.0**	**3,048,466**



Assets 2005*

	%	HK$ millions
Cash and short-term funds	19.5	502,730
Placings with banks maturing after one month and certificates of deposit	4.8	123,385
Trading assets	8.4	215,681
Advances to customers	38.8	999,326
Financial investments	15.3	394,497
Other	13.2	339,569
Total	100.0	2,575,188



* *Excluding Hong Kong SAR Government certificates of indebtedness*

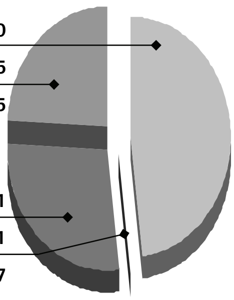
Financial Review (continued)

Customer Accounts

Customer accounts increased by HK$254.4 billion, or 14.7 per cent since the end of 2005. This excludes structured deposits, which rose by HK$26.0 billion, as these are included with 'Trading liabilities'.

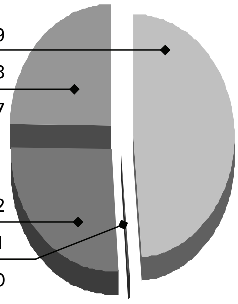
Customer accounts 2006

	%	HK$ millions
Hong Kong excluding Hang Seng Bank	**48.0**	**953,810**
Hang Seng Bank	**24.2**	**482,435**
Total Hong Kong	**72.2**	**1,436,245**
Rest of Asia-Pacific	**27.7**	**550,681**
Americas/Europe	**0.1**	**2,541**
Total	**100.0**	**1,989,467**



Customer accounts 2005

	%	HK$ millions
Hong Kong excluding Hang Seng Bank	48.7	844,779
Hang Seng Bank	24.8	430,828
Total Hong Kong	73.5	1,275,607
Rest of Asia-Pacific	26.3	456,652
Americas/Europe	0.2	2,851
Total	100.0	1,735,110



In Hong Kong, customer accounts rose by HK$160.6 billion, or 12.6 per cent, largely in savings and other account balances, attributable to successful deposit campaigns and effective pricing which made savings products more attractive to customers. Deposits from personal customers increased by HK$100.7 billion, or 12.2 per cent, as a result. In Commercial Banking and Corporate, Investment Banking and Markets, customer account balances grew by HK$59.9 billion, or 13.0 per cent, supported by targeted campaigns and a new, dedicated service team to capture the SME customer base, and there was continued growth in the payments and cash management business.

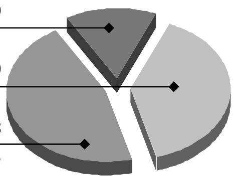
In the rest of Asia-Pacific, customer accounts increased by HK$94.0 billion, or 20.6 per cent, as the group actively sought to grow the deposit base throughout the region. Deposits from personal customers grew by HK$37.7 billion, or 23.0 per cent, notably in Singapore, Australia and China. Customer account balances held by corporate customers rose by HK$56.3 billion, or 19.8 per cent, largely in India, mainland China, Taiwan and Singapore.

The group's advances-to-deposits ratio fell to 52.5 per cent at 31 December 2006 from 57.6 per cent at 31 December 2005.

	2006	2005
Advances: deposits ratio (%)	**52.5**	57.6

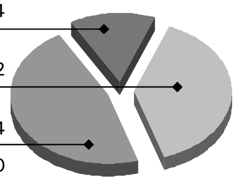
Customer accounts 2006

	%	HK$ millions
Current accounts	**14.7**	**292,450**
Savings accounts	**39.5**	**785,659**
Other deposit accounts	**45.8**	**911,358**
Total	**100.0**	**1,989,467**



Customer accounts 2005

	%	HK$ millions
Current accounts	14.1	245,094
Savings accounts	39.3	682,412
Other deposit accounts	46.6	807,604
Total	100.0	1,735,110



Equity

Equity increased by HK$51.0 billion, or 44.6 per cent, to HK$165.4 billion. The increase was principally due to the increase in retained earnings for the year and a rise in the available-for-sale securities reserve, which largely comprised the increase in the value of the group's 9.91 per cent investment in Ping An Insurance.

Capital Adequacy

The Hong Kong Monetary Authority ('HKMA') is the supervisor of the group on a consolidated basis. In this capacity, the HKMA sets minimum capital requirements for the group and the Bank and receives regular returns on capital adequacy. The HKMA broadly applies the guidelines for the international convergence of capital measurement and standards laid down by the Group of Ten central banks commonly known as the Basel Committee. Since the end of 1997, the capital adequacy rules have incorporated additional requirements for market risks which comprise foreign exchange, interest rate and equity risks.

The table on the right sets out an analysis of regulatory capital and capital adequacy ratios for the group at the end of 2006 and 2005.

Capital adequacy ratios including market risks, and calculated in accordance with the Third Schedule of the Hong Kong Banking Ordinance are shown in Note 48 on the Accounts on page 134.

The group's total capital adequacy ratio rose from 12.4 per cent at 31 December 2005 to 13.5 per cent at 31 December 2006. With effect from 1 January 2007, the group has adopted the 'standardised' approach of capital calculation under the HKMA 'Banking (Capital) Rules'. The increase in the group's total capital ratio at 31 December 2006 reflects additional capital raised in anticipation of different capital requirements under the new rules.

(HK$ millions)	2006	2005
Composition of capital		
Tier 1:		
Total shareholders' equity	**145,450**	97,334
Less: proposed dividend	**(6,500)**	(4,500)
property revaluation reserves*	**(7,892)**	(7,892)
available-for-sale investment reserve**	**(26,028)**	(3,051)
classified as regulatory reserve***	**(1,689)**	(1,319)
goodwill	**(4,182)**	(3,784)
others	**(138)**	1,769
Irredeemable non-cumulative preference shares	**51,735**	51,587
Minority interests****	**17,483**	14,808
Total qualifying tier 1 capital	**168,239**	144,952
Tier 2:		
Property revaluation reserves (@70%)	**5,524**	5,524
Available-for-sale investment reserve (@70%)	**18,220**	2,136
Collective impairment provision and regulatory reserve	**6,610**	5,112
Perpetual subordinated debt	**9,370**	9,359
Term subordinated debt	**9,849**	6,117
Term preference shares	**8,165**	3,877
Irredeemable cumulative preference shares	**16,563**	16,516
Total qualifying tier 2 capital	**74,301**	48,641
Deductions	**(58,559)**	(39,528)
Total capital	**183,981**	154,065
Risk-weighted assets	**1,367,607**	1,238,164
Capital adequacy ratios		
Total capital/risk-weighted assets (%)	**13.5**	12.4
Tier 1 capital/risk-weighted assets (%)	**12.3**	11.7

* *Includes the revaluation surplus on investment properties, which is now reported as part of retained profits.*
** *Includes adjustments made in accordance with guidelines issued by HKMA.*
*** *The regulatory reserve is maintained for the purpose of satisfying the Banking Ordinance for prudential supervision. Movements in this reserve are made in consultation with the HKMA.*
**** *After deduction of minority interests in unconsolidated subsidiary companies.*

Financial Review (continued)

Overdue and rescheduled advances

Overdue and rescheduled advances are shown in Notes 17c and 17d on the Accounts respectively on pages 77 to 79.

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

(HK$ millions)	Hong Kong	Rest of Asia-Pacific	Americas/ Europe	Others	Total
At 31 December 2006					
Gross advances to customers	**581,443**	**396,781**	**66,971**	**5,430**	**1,050,625**
Overdue advances to customers	**2,320**	**2,668**	**309**	**4**	**5,301**
At 31 December 2005					
Gross advances to customers	570,329	354,626	73,959	6,988	1,005,902
Overdue advances to customers	2,337	2,222	223	8	4,790

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 risk transfer, amounting to 10 per cent 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.

As at 31 December 2006

	Banks and Other Financial Institutions	Public Sector Entities	Other	Total
(HK$ millions)				
Americas				
United States	**62,558**	**78,354**	**72,669**	**213,581**
Other	**38,585**	**6,568**	**47,393**	**92,546**
	101,143	**84,922**	**120,062**	**306,127**
Europe				
United Kingdom	**138,625**	**17**	**24,324**	**162,966**
Other	**405,950**	**5,010**	**18,981**	**429,941**
	544,575	**5,027**	**43,305**	**592,907**
Asia-Pacific excluding Hong Kong	**213,292**	**93,968**	**116,242**	**423,502**

As at 31 December 2005

	Banks and Other Financial Institutions	Public Sector Entities	Other	Total
(HK$ millions)				
Americas				
United States	38,673	72,477	34,515	145,665
Other	39,328	9,909	50,744	99,981
	78,001	82,386	85,259	245,646
Europe				
United Kingdom	111,377	14	22,232	133,623
Other	338,060	5,842	39,509	383,411
	449,437	5,856	61,741	517,034
Asia-Pacific excluding Hong Kong	154,135	33,897	108,476	296,508

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 and insurance risk are discussed in detail in Note 51 on the Accounts on pages 140 to 155.

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 51 on the Accounts on pages 149 to 153.

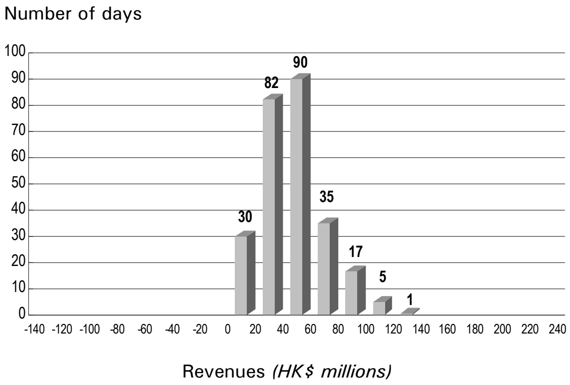
The average daily revenue earned from market risk-related treasury activities in 2006, including accrual book net interest income and funding related to dealing positions, was HK$46 million compared with HK$44 million in 2005. The standard deviation of these daily revenues was HK$23 million (HK$31 million for 2005).

An analysis of the frequency distribution of daily revenues shows that negative revenues did not occur on any day in 2006. The most frequent result was a daily revenue of between HK$40 million and HK$60 million with 90 occurrences. The highest daily revenue was HK$127 million. In 2005, the maximum daily loss was HK$55 million with nine out of 260 days showing negative revenues. The most frequent result in 2005 was a daily revenue of between HK$40 million and HK$60 million with 78 occurrences. The highest daily revenue in 2005 was HK$223 million.

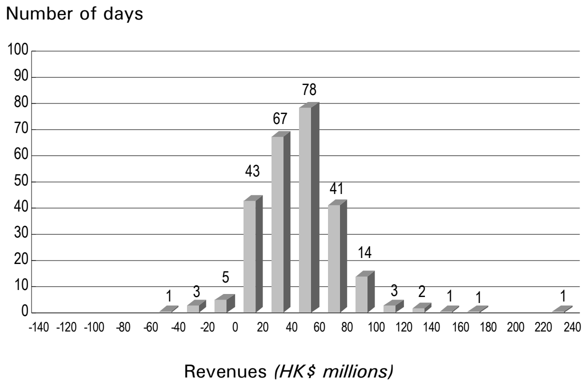
The average daily foreign exchange dealing revenue in 2006 was HK$14 million (HK$10 million for 2005). The standard deviation of these daily foreign exchange revenues in 2006 was HK$7 million (HK$7 million for 2005).

The average daily revenue earned from interest rate activities in 2006 was HK$30 million (HK$37 million for 2005). The standard deviation of these daily interest rate revenues in 2006 was HK$21 million (HK$29 million for 2005).

Daily distribution of market risk revenues 2006



Daily distribution of market risk revenues 2005



Profit and loss frequency

Financial Review (continued)

Operational Risk Management

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 learned 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 learned 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.

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 the 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 HSBC 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.

Consolidated Income Statement for the Year Ended 31 December 2006

	Note	**2006 HK$m**	2005 HK$m
Interest income	*4a*	**115,928**	80,199
Interest expense	*4b*	**(64,829)**	(36,708)
Net interest income		**51,099**	43,491
Fee income		**26,554**	21,671
Fee expense		**(4,150)**	(3,574)
Net fee income	*4c*	**22,404**	18,097
Net trading income	*4d*	**8,918**	7,180
Net income from financial instruments designated at fair value	*4e*	**2,670**	384
Gains less losses from financial investments	*4f*	**1,466**	756
Dividend income	*4g*	**749**	368
Net earned insurance premiums	*4h*	**21,846**	19,340
Other operating income	*4i*	**5,653**	4,897
Total operating income		**114,805**	94,513
Net insurance claims incurred and movement in policyholders' liabilities	*4j*	**(22,480)**	(17,291)
Net operating income before loan impairment charges and other credit risk provisions		**92,325**	77,222
Loan impairment charges and other credit risk provisions	*4k*	**(4,809)**	(2,064)
Net operating income		**87,516**	75,158
Employee compensation and benefits	*4l*	**(21,042)**	(17,736)
General and administrative expenses	*4m*	**(14,949)**	(12,095)
Depreciation of property, plant and equipment		**(1,905)**	(1,825)
Amortisation of intangible assets		**(343)**	(158)
Total operating expenses		**(38,239)**	(31,814)
Operating profit		**49,277**	43,344
Share of profit in associates and joint venture		**2,739**	1,905
Profit before tax		**52,016**	45,249
Tax expense	*5*	**(9,411)**	(8,051)
Profit for the year		**42,605**	37,198
Profit attributable to shareholders		**37,709**	32,873
Profit attributable to minority interests		**4,896**	4,325

Consolidated Balance Sheet at 31 December 2006

	Note	2006 HK$m	2005 HK$m
ASSETS			
Cash and short-term funds	9	**518,022**	502,730
Items in the course of collection from other banks		**46,519**	17,782
Placings with banks maturing after one month	10	**104,037**	69,554
Certificates of deposit	11	**73,200**	53,831
Hong Kong SAR Government certificates of indebtedness	12	**102,374**	97,344
Trading assets	13	**338,792**	215,681
Financial assets designated at fair value	14	**50,514**	37,073
Derivatives	15	**99,167**	72,039
Advances to customers	16	**1,043,782**	999,326
Financial investments	18	**484,841**	394,497
Amounts due from group companies		**161,118**	101,173
Investments in associates and joint venture	20	**25,534**	23,061
Goodwill and intangible assets	21	**10,428**	7,252
Property, plant and equipment	22	**29,159**	29,805
Deferred tax assets	32	**1,245**	1,272
Retirement benefit assets	41	**2,191**	1,788
Other assets	24	**59,917**	48,324
Total assets		**3,150,840**	2,672,532
LIABILITIES			
Hong Kong SAR currency notes in circulation	12	**102,374**	97,344
Items in the course of transmission to other banks		**57,226**	20,927
Deposits by banks	25	**108,125**	83,802
Customer accounts	26	**1,989,467**	1,735,110
Trading liabilities	27	**272,545**	250,198
Financial liabilities designated at fair value	28	**36,554**	33,291
Derivatives	15	**98,659**	72,009
Debt securities in issue	29	**69,195**	61,468
Retirement benefit liabilities	41	**465**	394
Amounts due to group companies		**31,356**	24,777
Other liabilities	30	**56,478**	46,628
Liabilities under insurance contracts issued	31	**61,350**	41,845
Current tax liabilities	5	**4,500**	2,044
Deferred tax liabilities	32	**4,284**	3,729
Subordinated liabilities	34	**16,353**	12,561
Preference shares	35	**76,464**	71,980
Total liabilities		**2,985,395**	2,558,107
EQUITY			
Share capital	36	**22,494**	22,494
Other reserves	37	**35,514**	6,037
Retained profits	37	**80,942**	64,303
Proposed fourth interim dividend	7	**6,500**	4,500
Total shareholders' equity		**145,450**	97,334
Minority interests	37	**19,995**	17,091
		165,445	114,425
Total equity and liabilities		**3,150,840**	2,672,532

Directors
Vincent H C Cheng
Michael R P Smith
Peter T S Wong

Secretary
M W Scales
5 March 2007

Balance Sheet at 31 December 2006

	Note	2006 HK$m	2005 HK$m
ASSETS			
Cash and short-term funds	9	**426,176**	430,129
Items in the course of collection from other banks		**40,434**	9,705
Placings with banks maturing after one month	10	**79,249**	53,205
Certificates of deposit	11	**33,907**	23,001
Hong Kong SAR Government certificates of indebtedness	12	**102,374**	97,344
Trading assets	13	**284,057**	173,169
Financial assets designated at fair value	14	**11,182**	8,755
Derivatives	15	**97,834**	70,328
Advances to customers	16	**686,468**	664,645
Financial investments	18	**243,223**	196,684
Amounts due from group companies		**169,117**	119,977
Investments in subsidiary companies	19	**7,828**	6,248
Investments in associates and joint venture	20	**17,508**	17,242
Goodwill and intangible assets	21	**3,360**	1,571
Property, plant and equipment	22	**16,635**	15,281
Deferred tax assets	32	**753**	782
Retirement benefit assets	41	**1,273**	1,252
Other assets	24	**46,652**	37,501
Total assets		**2,268,030**	1,926,819
LIABILITIES			
Hong Kong SAR currency notes in circulation	12	**102,374**	97,344
Items in the course of transmission to other banks		**50,618**	14,317
Deposits by banks	25	**90,787**	75,674
Customer accounts	26	**1,423,519**	1,247,079
Trading liabilities	27	**182,870**	175,127
Financial liabilities designated at fair value	28	**2,838**	1,959
Derivatives	15	**99,170**	71,410
Debt securities in issue	29	**34,494**	21,267
Retirement benefit liabilities	41	**447**	379
Amounts due to group companies		**47,601**	42,419
Other liabilities	30	**45,253**	37,690
Current tax liabilities	5	**2,412**	1,457
Deferred tax liabilities	32	**1,679**	1,238
Subordinated liabilities	34	**9,721**	9,703
Preference shares	35	**76,464**	71,980
Total liabilities		**2,170,247**	1,869,043
EQUITY			
Share capital	36	**22,494**	22,494
Other reserves	37	**26,923**	786
Retained profits	37	**41,866**	29,996
Proposed fourth interim dividend	7	**6,500**	4,500
Total equity		**97,783**	57,776
Total equity and liabilities		**2,268,030**	1,926,819

Directors
Vincent H C Cheng
Michael R P Smith
Peter T S Wong

Secretary
M W Scales
5 March 2007

Consolidated Statement of Recognised Income and Expense for the Year Ended 31 December 2006

	2006	2005
	HK$m	HK$m
Available-for-sale investments:		
– fair value changes taken to equity	**25,115**	(1,885)
– fair value changes transferred to the income statement on disposal or impairment	**(1,464)**	(787)
– fair value changes transferred to the income statement on hedged items due to hedged risk	**(105)**	1,077
Cash flow hedges:		
– fair value changes taken to equity	**(165)**	(2,743)
– fair value changes transferred to the income statement	**2,277**	538
Property revaluation:		
– fair value changes taken to equity	**1,977**	2,448
Share of changes in equity of associates and joint venture	**(186)**	1,098
Exchange differences	**2,779**	(782)
Actuarial gains on post-employment benefits	**93**	144
	30,321	(892)
Net deferred tax on items taken directly to equity	**(738)**	253
Total income and expense taken to equity during the year	**29,583**	(639)
Profit for the year	**42,605**	37,198
Total recognised income and expense for the year	**72,188**	36,559
Total recognised income and expense for the year attributable to:		
– shareholders	**66,448**	32,594
– minority interests	**5,740**	3,965
	72,188	36,559

Consolidated Cash Flow Statement for the Year Ended 31 December 2006

	Note	**2006** **HK$m**	2005 HK$m
Operating activities			
Cash generated from operations	*40*	**88,942**	31,009
Interest received on financial investments		**17,527**	14,759
Dividends received on financial investments		**711**	339
Dividends received from associates		**766**	108
Taxation paid		**(6,159)**	(7,313)
Net cash inflow from operating activities		**101,787**	38,902
Investing activities			
Purchase of financial investments		**(402,459)**	(335,668)
Proceeds from sale or redemption of financial investments		**361,794**	366,294
Purchase of property, plant and equipment		**(2,085)**	(1,749)
Proceeds from sale of property, plant and equipment		**2,697**	1,153
Purchase of other intangible assets		**(1,142)**	(670)
Proceeds from sale of assets held for sale		**1,479**	–
Net cash outflow in respect of the acquisition of and increased shareholding in subsidiary companies	*41c*	**(22)**	(1,644)
Net cash inflow in respect of the sale of subsidiary companies	*41d*	**409**	151
Net cash outflow in respect of the purchase of interests in business portfolios	*41f*	**(775)**	–
Net cash outflow in respect of the purchase of interests in associates and joint venture		**(462)**	(3,358)
Proceeds from the sale of interests in business portfolios	*41e*	**16,501**	–
Proceeds from the sale of interests in associates		**–**	10
Net cash (outflow) / inflow from investing activities		**(24,065)**	24,519
Net cash inflow before financing		**77,722**	63,421
Financing			
Issue of preference share capital		**4,277**	16,567
Change in minority interest stake		**976**	362
Repayment of subordinated liabilities		**(1,018)**	–
Issue of subordinated liabilities		**4,661**	2,500
Ordinary dividends paid		**(18,757)**	(20,600)
Dividends paid to minority interests		**(3,841)**	(3,983)
Interest paid on preference shares		**(3,935)**	(1,574)
Interest paid on subordinated liabilities		**(946)**	(555)
Net cash outflow from financing		**(18,583)**	(7,283)
Increase in cash and cash equivalents	*41a*	**59,139**	56,138

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 subsidiary companies ('the group') made up to 31 December 2006.

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

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

b The consolidated financial statements include the attributable share of the results and reserves of associates and joint venture based on accounts made up to dates not earlier than three months prior to 31 December 2006.

2 Critical accounting estimates and judgments in applying accounting policies

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

Fair value estimation

As disclosed in note 3, a significant proportion of the group's financial assets and liabilities are stated in the balance sheet at fair value. Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Where there is an active market for financial assets and liabilities and quoted prices are available, then such prices are the best indicator of fair value. In the normal course of business, however, the group also holds financial assets and liabilities, including certain non-exchange traded derivatives, where quoted prices in an active market are not available. As disclosed in note 3h, the group uses valuation techniques to determine the fair value of such financial instruments. The valuation techniques used for different financial instruments are selected to reflect how the market would be expected to price the instruments, using inputs that reasonably reflect the risk-return factors inherent in the instruments. Depending upon the characteristics of the financial instruments concerned, observable market factors are available for use in most valuations, while others involve a greater degree of judgment and estimation.

In the case of trading assets and liabilities, derivatives, and financial assets and liabilities designated at fair value, the estimation of fair value at the reporting date affects profit for the year. The group has, and maintains, a substantial pool of expertise in the valuation of financial instruments and valuation estimates are benchmarked against actual outcomes, where practicable, to ensure that the valuation techniques reflect actual market activity.

Accounting standards also require disclosure of the estimated fair value of certain financial instruments that are stated in the balance sheet at amortised cost. These disclosures, which are made in the notes on the financial statements, affect neither the profit for the year nor the carrying amounts of any assets or liabilities in the balance sheet. The estimation of fair value of some of these classes of assets and liabilities is performed in the absence of active markets for instruments with similar characteristics. The amounts disclosed, therefore, may involve a higher degree of judgment and estimation than is the case for most of the assets and liabilities which are carried at fair value on the balance sheet. For example, the fair value of advances to customers as disclosed in note 16a generally used the following estimation methods and assumptions:

- for advances maturing within one year, the fair value is generally assumed to be the same as the book value unless there is reason to believe that the credit spread has changed;
- for advances maturing or repricing after one year, the fair value is estimated on repricing at the current interest rate; and in addition,
- for large corporate facilities, fair value is estimated by reference to the credit spread that would currently apply to a new loan on similar terms.

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

Loan impairment

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

For individually significant loans, judgment 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, judgment 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 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.

Special purpose entities

In the normal course of business, the group participates, in a variety of ways, in financial structures involving special purpose entities. Judgment is required in determining whether the rights and obligations taken on result in the group having control of the special purpose entity and whether it should be included in the consolidated financial statements as a subsidiary.

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 judgment 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 assurance 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 21b. 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 claims 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 31.

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

Income taxes

The group is subject to income taxes in many jurisdictions and significant judgment is required in estimating the group's provision for income taxes. There are many transactions and interpretations of tax law for which the final outcome will not be established until some time later. The group recognises liabilities for taxation based on estimates of whether additional taxes will be payable. The estimation process includes seeking expert advice where appropriate.

Where the final liability for taxation is different from the amounts that were initially recorded, these differences will affect the income tax and deferred tax provisions in the period in which the estimate is revised or the final liability is established.

Held-to-maturity securities

As indicated in note 3g, 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 judgment 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 2006 are disclosed in note 11 and 18a on the accounts.

3 Principal 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 rates of the financial assets or financial liabilities to which they relate.

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.

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 3d 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 3a).

(ii) Dividend income

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

---

c *Advances to customers and placings with banks*

Advances to customers and placings with banks are loans and advances originated by the group, which have not been classified as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are initially recorded at fair value plus any transaction costs and are subsequently measured at amortised cost using the effective interest rate method, less impairment losses.

Loans and advances classified as held for trading or designated at fair value are reported as trading instruments, or financial instruments designated at fair value, respectively (note 3e and 3f).

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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 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.

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. 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;

3 Principal accounting policies *(continued)*

- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC 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.

Incurred but not yet identified impairment

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. The loss 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 loss rates having regard to the period of time for which a customer's loan is overdue. 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.

(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 that have been individually identified as impaired and whose terms have been subsequently renegotiated and which have been performing satisfactorily for a certain period are no longer treated as impaired.

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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.

3 Principal accounting policies *(continued)*

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'.

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*

Available-for-sale securities

Treasury bills, debt securities and equity shares intended to be held on a continuing basis are classified as available-for-sale securities unless they have been designated at fair value (see note 3f) or they are classified as held-to-maturity (see below). Available-for-sale securities are initially measured at fair value (which is usually the same as the consideration paid) plus direct and incremental transaction costs. They are subsequently remeasured at fair value.

Changes in fair value, net of accrued interest, are recognised in equity until the securities are either sold or impaired. On the sale of available-for-sale securities, cumulative gains or losses previously recognised in equity are recognised through the income statement and classified as 'Gains less losses from financial investments'.

An assessment is made at each balance sheet date as to whether there is any objective evidence of impairment, being circumstances where an adverse impact on estimated future cash flows of the financial asset or group of assets can be reliably estimated.

3 Principal accounting policies *(continued)*

If an available-for-sale security is determined to be impaired, the cumulative loss (measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in the income statement) is removed from equity and recognised in the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases 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. Impairment losses on equity instruments previously recognised in the income statement that are no longer required are reversed through reserves, not through the income statement.

Gains and losses resulting from foreign exchange are recognised in reserves for available-for-sale equity securities and in the income statement for available-for sale debt securities.

Interest income on available-for-sale securities is recognised in accordance with note 3a.

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.

Financial investments are recognised using trade date accounting.

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 held 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 derivatives, 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.

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.

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. Conversely, securities purchased under commitments to sell (‘reverse repos’) are not recognised on the balance sheet and the consideration paid is recorded in ‘Trading assets’.

The difference between the sale and repurchase price is recognised as ‘Net trading income’ over the life of the agreement.

Securities lending and borrowing transactions are generally entered into on a collateralised basis, with securities or cash advanced or received as collateral. The transfer of the securities to counterparties is not normally reflected on the balance sheet. If cash collateral is advanced or received, an asset or liability is recorded at the amount of cash collateral advanced or received within ‘Trading assets’.

3 Principal accounting policies *(continued)*

Securities borrowed are not recognised on the balance sheet, unless they are sold to third parties, in which case the 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. If observable market data are not available, the initial change in fair value indicated by the valuation model, but based on unobservable inputs, is not recognised immediately in the income statement but is recognised in the income statement either: over the life of the transaction on an appropriate basis; or recognised in the income statement when the inputs become observable; or when the transaction matures or is closed out.

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. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement in 'Net trading income', as discussed in note 3f. All gains and losses from changes in the fair value of any derivative instrument that does not qualify for hedge accounting under HKAS 39 are recognised immediately in the income statement and reported in 'Net trading income', except where derivative contracts are used with financial instruments designated at fair value, in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'.

Where derivatives are designated and highly effective 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 Principal 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 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 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.

For fair value hedge relationships, the cumulative dollar offset method or regression analysis are used to test hedge effectiveness. For cash flow hedge relationships, effectiveness is tested by applying the change in variable cash flow method or the cumulative dollar offset method using the hypothetical derivative approach.

3 Principal accounting policies *(continued)*

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 per cent to 125 per cent.

k *Derecognition of financial assets and liabilities*

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

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

l *Offsetting financial assets and financial liabilities*

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

m *Subsidiaries, associates and joint venture*

The group

Subsidiaries are companies which the group, directly or indirectly, control. 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 or controls the composition of the board of directors. 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. Minority 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 venture in the consolidated balance sheet are stated at the group's attributable share of the net assets of the associates and joint venture using the equity method of accounting.

Share of profit in associates and joint venture is stated in the income statement net of tax.

The Bank

The Bank's investments in subsidiaries, associates and joint venture are stated at cost less impairment losses, if any.

3 Principal accounting policies *(continued)*

n *Goodwill and intangible assets*

(i) Goodwill arises on business combinations, including the acquisition of subsidiaries 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. Goodwill on acquisitions of associates is included in 'Investments in associates'. Goodwill is tested for impairment annually by comparing the present value of the expected future cash flows from a business with the carrying value of its net assets, including attributable goodwill. Goodwill is allocated to cash-generating units for the purposes of impairment testing. Goodwill is tested for impairment at the lowest level at which goodwill is monitored for internal management purposes. Goodwill is stated at cost less accumulated impairment losses which are charged to the income statement.

Negative goodwill is recognised immediately in the income statement when it arises.

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.

(ii) Intangible assets include the value of in-force long-term assurance business, computer software, 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 value of in-force long-term assurance 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 value of the in-force long-term assurance business is set out in note 3v.

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o *Property, plant and equipment*

(i) Premises

Premises held for own use, comprising freehold land and buildings, and 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, are stated at valuation less accumulated depreciation and impairment losses.

Such premises are revalued by professionally 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 premises, and are thereafter taken to the 'Property revaluation reserve'. Deficits arising on revaluation are firstly set off against any previous revaluation surpluses included in the 'Property revaluation reserve' in respect of the same premises, and are thereafter recognised in the income statement.

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

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

- freehold land is not depreciated;
- leasehold land is depreciated over the unexpired terms of the leases;
- 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.

3 Principal accounting policies *(continued)*

(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.

(iv) Leasehold land and land use rights

The Government of the Hong Kong SAR owns all the land in Hong Kong and permits its use under leasehold arrangements. Where the cost of land is known or can be reliably determined at the inception of the lease, 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 premises, as discussed above.

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

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

(iv) There are no freehold interests in land in Hong Kong. Accordingly all such land is considered to be held under operating leases. Unless it qualifies for inclusion in 'Property, plant and equipment' (as described in note 3o above), such land is included under 'Other assets' in the balance sheet 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 between 20 and 999 years.

3 Principal accounting policies *(continued)*

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 reserves, in which case it is recognised in reserves.

(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 balance sheet 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 balance sheet 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 directly in equity, is also credited or charged directly to equity.

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 equity, is also credited or charged directly to equity and are recognised in the income statement when the deferred 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 changes in equity 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 recognised in the balance sheet represents the excess of the fair value of plan assets over the present value of the defined benefit obligations adjusted for unrecognised past service costs. The asset is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

Notes on the Financial Statements (continued)

3 Principal accounting policies *(continued)*

s *Share-based payments*

The group grants shares of HSBC Holdings plc to certain employees under various vesting conditions and the group has the obligation to acquire HSBC Holdings plc shares to deliver to the employees upon vesting. The group's liability under such arrangements is measured at fair value at each reporting date. The changes in fair value are recognised as an expense in each period. The main kinds of awards in this category are as follows:

- shares awarded to an employee to join HSBC that are made available immediately, with no vesting period attached to the award, are expensed immediately;
- when an inducement in the form of shares is awarded to an employee on commencement of employment with HSBC, and the employee must complete a specified period of service before the inducement vests, the expense is spread over the period to vesting;
- discretionary bonuses awarded in respect of service in the past, are expensed over the vesting period which, in this case, is the period from the date the bonus is announced until the award vests.

For share options granted to employees of the group directly by HSBC Holdings plc, the compensation expense to be spread over the vesting period is determined by reference to the fair value of the options on grant date, and the impact of any non-market vesting conditions such as option lapses. The expense is recognised over the vesting period. The corresponding amount is credited to 'Other reserves'.

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.

3 Principal accounting policies *(continued)*

v *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 general insurance business are reported as income over the term of the insurance contract attributable to the risks borne during the accounting period. The unearned premium or 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 assurance are accounted for when receivable, except in unit-linked business 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 to which they relate.

Claims and reinsurance recoveries

Gross insurance claims for general insurance business include paid claims and movements in outstanding claims reserves. The outstanding claims reserves are based on the estimated ultimate cost of all claims that have occurred 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. Reserves for claims incurred but not reported ('IBNR') are made on an estimated basis, using appropriate statistical techniques.

Gross insurance claims for life assurance 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. The reserves for non-linked liabilities (long-term business provision) are calculated by each life assurance operation based on local actuarial principles. The reserves for linked liabilities are at least the element of any surrender or transfer value which is calculated by reference to the relevant fund or funds or index. 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'.

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

Value of long-term assurance business

A value is placed on insurance contracts that are classified as long-term assurance business, and are in force at the balance sheet date.

The value of in-force long-term assurance business is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as recent experience and general economic conditions. Movements in the value of in-force long-term assurance business are included in 'Other operating income' gross of tax.

3 Principal accounting policies *(continued)*

w *Investment contracts*

Customer liabilities under unit-linked investment contracts, along with the linked financial assets, are designated as held at fair value, and the movements in fair value are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

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

x *Dividends*

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

y *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'.

z *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.

aa *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*

	2006	2005
	HK$m	HK$m
Interest income on listed securities	**2,035**	1,764
Interest income on unlisted securities	**25,217**	18,356
Other interest income	**98,205**	65,614
	125,457	85,734
Less: interest income classified as 'Net trading income' (note 4d)	**(9,073)**	(4,989)
Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 4e)	**(456)**	(546)
	115,928	80,199

Included in the above is interest income accrued on impaired financial assets of HK$309 million (*2005: HK$208 million*), including unwinding of discounts on loan impairment losses of HK$196 million *(2005: HK$81 million).*

4 Operating profit *(continued)*

b *Interest expense*

	2006	2005
	HK$m	HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**1,451**	1,243
Interest expense on preference shares	**4,512**	3,010
Other interest expense	**69,333**	38,968
	75,296	43,221
Less: interest expense classified as 'Net trading income' (note 4d)	**(10,380)**	(6,473)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4e)	**(87)**	(40)
	64,829	36,708

c *Net fee income*

	2006	2005
	HK$m	HK$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	**8,543**	7,921
– fee expense	**(1,292)**	(1,607)
	7,251	6,314
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**6,221**	4,645
– fee expense	**(516)**	(295)
	5,705	4,350

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

d *Net trading income*

	2006 HK$m	2005 HK$m
Dealing profits		
– Foreign exchange	**6,995**	5,548
– Interest rate derivatives	**1,171**	2,442
– Debt securities	**281**	278
– Equities and other trading	**1,554**	292
	10,001	8,560
Gain/(loss) from hedging activities		
Fair value hedges		
– Net gain/(loss) on hedged items attributable to the hedged risk	**116**	(1,085)
– Net (loss)/gain on hedging instruments	**(95)**	1,085
Cash flow hedges		
– Net hedging loss	**(5)**	(1)
	16	(1)
Interest on trading assets and liabilities		
– Interest income (note 4a)	**9,073**	4,989
– Interest expense (note 4b)	**(10,380)**	(6,473)
	(1,307)	(1,484)
Dividend income from trading securities		
– Listed investments	**208**	105
	8,918	7,180

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

	2006 HK$m	2005 HK$m
Income on assets designated at fair value which back insurance and investment contracts	**4,977**	1,186
Change in fair value of investment contracts relating to insurance entities	**(2,687)**	(1,164)
	2,290	22
Net change in fair value of other financial assets/liabilities designated at fair value	**11**	(144)
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4a)	**456**	546
– Interest expense (note 4b)	**(87)**	(40)
	369	506
	2,670	384

4 Operating profit *(continued)*

f *Gains less losses from financial investments*

	2006	2005
	HK$m	HK$m
Profit on disposal of available-for-sale securities	**1,466**	762
Other	**–**	(6)
	1,466	756

g *Dividend income*

	2006	2005
	HK$m	HK$m
Listed investments	**273**	102
Unlisted investments	**476**	266
	749	368

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

h *Net earned insurance premiums*

2006	*Non-life insurance*	*Life insurance (non-linked)*	*Life insurance (linked)*	*Investment contracts with discretionary participation features*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Gross written premiums	**2,088**	**17,173**	**3,080**	**64**	**22,405**
Movement in unearned premiums	**(51)**	**–**	**–**	**–**	**(51)**
Gross earned premiums	**2,037**	**17,173**	**3,080**	**64**	**22,354**
Gross written premiums ceded to reinsurers	**(364)**	**(118)**	**(6)**	**–**	**(488)**
Reinsurers' share of movement in unearned premiums	**(20)**	**–**	**–**	**–**	**(20)**
Reinsurers' share of gross earned premiums	**(384)**	**(118)**	**(6)**	**–**	**(508)**
Net earned premiums	**1,653**	**17,055**	**3,074**	**64**	**21,846**

2005	*Non-life insurance*	*Life insurance (non-linked)*	*Life insurance (linked)*	*Investment contracts with discretionary participation features*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m
Gross written premiums	2,009	16,358	1,453	84	19,904
Movement in unearned premiums	(54)	–	–	–	(54)
Gross earned premiums	1,955	16,358	1,453	84	19,850
Gross written premiums ceded to reinsurers	(397)	(93)	(5)	–	(495)
Reinsurers' share of movement in unearned premiums	(15)	–	–	–	(15)
Reinsurers' share of gross earned premiums	(412)	(93)	(5)	–	(510)
Net earned premiums	1,543	16,265	1,448	84	19,340

4 Operating profit *(continued)*

i *Other operating income*

	2006	2005
	HK$m	HK$m
Rental income from investment properties	**196**	215
Movement in present value of in-force insurance business	**1,124**	1,185
Gains on investment properties	**475**	1,167
Profit on disposal of property, plant and equipment, and assets held for sale	**981**	111
Profit on disposal of subsidiaries, associates and business portfolios	**904**	53
Surplus arising on property revaluation	**70**	370
Other	**1,903**	1,796
	5,653	4,897

Gains on investment properties comprise unrealised revaluation gains, together with realised profit on disposals.

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

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

2006	*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**
Claims, benefits and surrenders paid	**788**	**825**	**2,143**	**1**	**3,757**
Movement in provision	**(41)**	**16,740**	**2,066**	**46**	**18,811**
Gross claims incurred and movement in policyholders' liabilities	**747**	**17,565**	**4,209**	**47**	**22,568**
Reinsurers' share of claims, benefits and surrenders paid	**(94)**	**(36)**	**(1)**	**–**	**(131)**
Reinsurers' share of movement in provision	**45**	**(2)**	**–**	**–**	**43**
Reinsurers' share of claims incurred and movement in policyholders' liabilities	**(49)**	**(38)**	**(1)**	**–**	**(88)**
Net insurance claims incurred and movement in policyholders' liabilities	**698**	**17,527**	**4,208**	**47**	**22,480**

2005	*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
Claims, benefits and surrenders paid	713	460	1,071	–	2,244
Movement in provision	(106)	14,408	741	70	15,113
Gross claims incurred and movement in policyholders' liabilities	607	14,868	1,812	70	17,357
Reinsurers' share of claims, benefits and surrenders paid	(118)	(32)	(2)	–	(152)
Reinsurers' share of movement in provision	86	1	(1)	–	86
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(32)	(31)	(3)	–	(66)
Net insurance claims incurred and movement in policyholders' liabilities	575	14,837	1,809	70	17,291

4 Operating profit *(continued)*

k *Loan impairment charges and other credit risk provisions*

Net charge for impairment of customer advances	**2006 HK$m**	2005 HK$m
– Individually assessed impairment allowances:		
New allowances	**1,314**	2,129
Releases	**(869)**	(1,755)
Recoveries	**(212)**	(267)
	233	107
– Net charge for collectively assessed impairment allowances	**4,468**	1,961
Net charge/(release) of other credit risk provisions	**108**	(4)
Net charge for loan impairment and other credit risk provisions	**4,809**	2,064

l *Employee compensation and benefits*

	2006 HK$m	2005 HK$m
Wages, salaries and other costs	**14,302**	12,311
Performance-related pay	**5,501**	4,117
Social security costs	**283**	238
Retirement benefit costs		
– Defined contribution plans	**384**	284
– Defined benefit plans	**557**	778
– Other retirement benefits	**15**	8
	21,042	17,736

Retirement benefit pension plans

The group operates 56 *(2005: 52)* retirement benefits plans, with a total cost of HK$956 million *(2005: HK$1,070 million)*, of which HK$313 million *(2005: HK$275 million)* relates to overseas plans and HK$48 million *(2005: HK$270 million)* are sponsored by HSBC Asia Holdings BV.

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

The group's defined benefit plans, which cover 47% *(2005: 50%)* of the group's 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$504 million *(2005: HK$739 million)* 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.

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

(i) Defined benefit plan principal actuarial assumptions

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

	2006	2005
	% p.a.	% p.a.
Discount rate	**3.75**	4.20
Expected rate of return on plan assets		
– equities	**8.0**	8.0
– bonds	**4.0**	4.0
– other	**5.0**	5.0
Inflation assumption	**n/a**	n/a
Rate of increase for pensions in payment	**n/a**	n/a
Rate of pay increase		
– long term	**3.0**	3.0
Mortality table	**HKLT2001***	HKLT1995**

* *HKLT2001 – Hong Kong Life Tables 2001*

** *HKLT1995 – Hong Kong Life Tables 1995*

The overall expected long-term rate of return on assets is 5.0%. 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.

(ii) Value recognised in the balance sheet

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Equities	**5,865**	4,955	**3,088**	2,784
Bonds	**6,620**	6,055	**4,364**	3,925
Other	**2,375**	2,334	**2,048**	1,890
Fair value of plan assets	**14,860**	13,344	**9,500**	8,599
Present value of funded obligations	**12,830**	11,753	**8,382**	7,538
Present value of unfunded obligations	**304**	197	**292**	188
Defined benefit obligations	**13,134**	11,950	**8,674**	7,726
Net defined benefit asset	**1,726**	1,394	**826**	873
Reported as 'Assets'	**2,191**	1,788	**1,273**	1,252
Reported as 'Liabilities'	**(465)**	(394)	**(447)**	(379)
Net defined benefit asset	**1,726**	1,394	**826**	873

4 Operating profit *(continued)*

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

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**11,950**	11,626	**7,726**	7,389
Current service cost	**720**	742	**481**	493
Interest cost	**511**	481	**336**	307
Contributions by employees	**2**	2	**1**	1
Actuarial (gains)/losses	**860**	(77)	**672**	12
Benefits paid	**(914)**	(860)	**(563)**	(482)
Gains on curtailments	**(1)**	–	**–**	–
Losses on settlements	**–**	7	**–**	7
Exchange and other movements	**6**	29	**21**	(1)
At 31 December	**13,134**	11,950	**8,674**	7,726

(iv) Changes in the fair value of plan assets

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**13,344**	12,606	**8,599**	8,095
Expected return	**721**	722	**441**	455
Contributions by the group	**667**	736	**438**	454
Contributions by employees	**2**	2	**1**	1
Actuarial gains/(losses)	**953**	67	**499**	(5)
Benefits paid	**(840)**	(830)	**(489)**	(455)
Exchange and other movements	**13**	41	**11**	54
At 31 December	**14,860**	13,344	**9,500**	8,599

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

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Equities	**589**	606	**522**	437
Others	**4**	–	**–**	–
	593	606	**522**	437

The actual return on plan assets for the year ended 31 December 2006 was HK$1,674 million *(2005: HK$789 million)*.

The group expects to make HK$669 million of contributions to defined benefit pension plans during the following year (*2005: HK$706 million*). Contributions to be made by the Bank are expected to be HK$443 million (*2005: HK$419 million*).

4 Operating profit *(continued)*

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

	Group	
	2006	2005
	HK$m	HK$m
Current service cost	**720**	742
Interest cost	**511**	481
Expected return on plan assets	**(721)**	(722)
(Gains)/losses on curtailments and settlements	**(1)**	7
Total net expense	**509**	508

Total net actuarial losses recognised in the group's retained profits during 2006 in respect of defined benefit pension plans after deduction of minority interests were HK$8 million *(2005: HK$73 million gain)*. Total net actuarial gains recognised outside of the income statement to date after deduction of minority interests were HK$49 million *(2005: HK$57 million gain).*

Total net actuarial losses recognised in the Bank's retained profits during 2006 in respect of defined benefit pension plans were HK$173 million *(2005: HK$17 million loss)*. Total net actuarial losses recognised outside of the income statement to date were HK$196 million *(2005: HK$23 million loss).*

The total effect of the limit on plan surpluses in 2006 in respect of defined benefit pension plans was HK$nil *(2005: HK$nil)*.

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.

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:

Assumptions as at 31 December	**2006**	2005
	% p.a.	% p.a.
Inflation	**3.00**	2.70
Salary increases	**4.75**	4.45
Pension increases	**3.00**	2.70
Discount rate	**5.10**	4.75
Expected return on assets	**5.89**	4.80
Mortality table	**PA92C2005***	PA92C2036**

* *The table "PA92C2005" was based on the 92 series of tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries, projected to the year 2005 in line with standard (CMIR17) improvements underlying the series and allowing for future improvements in mortality after 2005 in line with those underlying the medium cohort improvements applicable to the series.*

** *The table "PA92C2036" was based on the 92 series of tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries, projected to the year 2036 allowing for improvements in mortality underlying the series.*

4 Operating profit *(continued)*

The International Staff Scheme

Funded status at 31 December	**2006**	2005
	£m	£m
Plan assets	**504**	510
Defined benefit obligations	**(601)**	(575)
Net defined benefit liabilities	**(97)**	(65)

Categories of assets at 31 December	**2006**	2005
	£m	£m
Bonds	**423**	250
Property	**49**	46
Other	**32**	214
Fair value of plan assets	**504**	510

Reconciliation of defined benefit obligations at 31 December	**2006**	2005
	£m	£m
At 1 January	**575**	493
Current service cost	**17**	15
Interest cost	**27**	26
Contributions by employees	**1**	2
Actuarial losses	**26**	62
Benefits paid	**(47)**	(23)
Special termination benefit cost	**2**	–
At 31 December	**601**	575

Reconciliation of the fair value of plan assets at 31 December	**2006**	2005
	£m	£m
At 1 January	**510**	417
Expected return	**24**	23
Actuarial (losses)/gains	**(8)**	37
Contributions by the group	**24**	54
Contributions by employees	**1**	2
Benefits paid	**(47)**	(23)
At 31 December	**504**	510

Estimated contributions in the following year	**2006**	2005
	£m	£m
Estimated company contributions in the financial year	**15**	15
Estimated employee contributions in the financial year	**1**	2
Estimated total contributions in the financial year	**16**	17

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

(vi) Amounts for the current and previous years

	Group					Bank				
	2006	2005	2004	2003	2002	**2006**	2005	2004	2003	2002
	HK$m	HK$m	HK$m	HK$m	HK$m	**HK$m**	HK$m	HK$m	HK$m	HK$m
Defined benefit obligations	**13,134**	11,950	11,626	10,329	9,829	**8,674**	7,726	7,389	6,714	6,311
Plan assets	**14,860**	13,344	12,606	11,561	10,245	**9,500**	8,599	8,095	7,534	6,730
Net surplus	**1,726**	1,394	980	1,232	416	**826**	873	706	820	419
Experience losses/(gains) on plan liabilities	**420**	84	(28)	(281)	(410)	**384**	71	(76)	(230)	(270)
Experience gains/(losses) on plan assets	**953**	67	99	611	(1,028)	**499**	(5)	9	283	(517)

m *General and administrative expenses*

	2006	2005
	HK$m	HK$m
Premises and equipment		
– Rental expenses	**1,557**	1,243
– Amortisation of prepaid operating lease payments	**58**	56
– Other premises and equipment	**2,463**	2,089
	4,078	3,388
Marketing and advertising expenses	**3,587**	2,840
Other administrative expenses	**7,268**	5,554
Litigation and other provisions	**16**	313
	14,949	12,095

Included in operating expenses are direct operating expenses of HK$27 million *(2005: HK$26 million)* 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$3 million *(2005: HK$3 million)*.

Included in operating expenses are minimum lease payments under operating leases of HK$1,497 million *(2005: HK$1,143 million)*.

n *Auditors' remuneration*

Auditors' remuneration amounted to HK$58 million *(2005: HK$59 million),* of which HK$29 million *(2005: HK$29 million)* related to the Bank.

o *Directors' emoluments*

Key management compensation includes the aggregate emoluments of the directors of the Bank calculated in accordance with section 161 of the Hong Kong Companies Ordinance of HK$137 million *(2005: HK$115 million)*. This comprises fees of HK$7 million *(2005: HK$7 million)* and other emoluments of HK$130 million *(2005: HK$108 million)* which includes pension benefits of HK$4 million *(2005: HK$4 million)*.

5 Tax expense

a The Bank and its subsidiary companies in Hong Kong have provided for Hong Kong profits tax at the rate of 17.5% *(2005: 17.5%)* on the profits for the year assessable in Hong Kong. Overseas branches and subsidiary companies have similarly provided for tax in the countries in which they operate at the appropriate rates of tax ruling in 2006. Deferred taxation is provided for in accordance with the group's accounting policy in note 3q.

The charge for taxation in the income statement comprises:

	2006	2005
	HK$m	HK$m
Current income tax		
– Hong Kong profits tax – on current year profit	**5,664**	4,982
– Hong Kong profits tax – adjustments in respect of prior years	**(158)**	(8)
– Overseas taxation – on current year profit	**4,192**	2,622
– Overseas taxation – adjustments in respect of prior years	**(237)**	(24)
	9,461	7,572
Deferred tax (note 32)		
– Origination and reversal of temporary differences	**(142)**	703
– Adjustments in respect of prior years	**92**	(224)
	(50)	479
	9,411	8,051

b *Provisions for taxation*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong profits tax	**2,229**	635	**598**	117
Overseas taxation	**2,271**	1,409	**1,814**	1,340
Current tax liabilities	**4,500**	2,044	**2,412**	1,457
Deferred tax liabilities (note 32)	**4,284**	3,729	**1,679**	1,238
	8,784	5,773	**4,091**	2,695

Notes on the Financial Statements (continued)

5 Tax expense *(continued)*

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

	2006 HK$m	2005 HK$m
Profit before tax	**52,016**	45,249
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**9,952**	8,714
Tax effect of non-taxable revenue (net of non-deductible expenses)	**(260)**	(645)
Tax effect of prior year's tax losses utilised this year (net of unused tax losses not recognised)	**(86)**	(21)
Over provision in prior years	**(303)**	(206)
Others	**108**	209
	9,411	8,051

6 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$32,532 million *(2005: HK$27,578 million)* which has been dealt with in the accounts of the Bank.

7 Dividends

	2006		2005	
	HK$ per share	**HK$m**	HK$ per share	HK$m
Ordinary dividends				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	**0.50**	**4,500**	0.53	4,800
– first interim dividend paid	**0.42**	**3,757**	0.51	4,600
– second interim dividend paid	**0.61**	**5,500**	0.67	6,000
– third interim dividend paid	**0.55**	**5,000**	0.58	5,200
	2.08	**18,757**	2.29	20,600

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2006 of HK$6,500 million (HK$0.72 per ordinary share).

8 Financial Assets and Liabilities

Group

	At 31 December 2006								
	Held for trading	*Designated at fair value*	*Held-to-maturity securities*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
ASSETS									
Cash and short-term funds	–	–	–	**397,689**	**108,722**	**11,611**	–	–	**518,022**
Items in the course of collection from other banks	–	–	–	–	–	**46,519**	–	–	**46,519**
Placings with banks maturing after one month	–	–	–	**104,037**	–	–	–	–	**104,037**
Certificates of deposit	–	–	**2,912**	–	**70,288**	–	–	–	**73,200**
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	**102,374**	–	–	**102,374**
Trading assets	**338,792**	–	–	–	–	–	–	–	**338,792**
Financial assets designated at fair value	–	**50,514**	–	–	–	–	–	–	**50,514**
Derivatives	**94,747**	–	–	–	–	–	**672**	**3,748**	**99,167**
Advances to customers	–	–	–	**1,043,782**	–	–	–	–	**1,043,782**
Financial investments	–	–	**40,407**	–	**444,434**	–	–	–	**484,841**
Amounts due from group companies	**33,428**	–	–	–	–	**127,690**	–	–	**161,118**
Other assets	–	–	–	–	–	**53,150**	–	–	**53,150**
Total financial assets	**466,967**	**50,514**	**43,319**	**1,545,508**	**623,444**	**341,344**	**672**	**3,748**	**3,075,516**
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	**102,374**	–	–	**102,374**
Items in the course of transmission to other banks	–	–	–	–	–	**57,226**	–	–	**57,226**
Deposits by banks	–	–	–	–	–	**108,125**	–	–	**108,125**
Customer accounts	–	–	–	–	–	**1,989,467**	–	–	**1,989,467**
Trading liabilities	**272,545**	–	–	–	–	–	–	–	**272,545**
Financial liabilities designated at fair value	–	**36,554**	–	–	–	–	–	–	**36,554**
Derivatives	**97,848**	–	–	–	–	–	**493**	**318**	**98,659**
Debt securities in issue	–	–	–	–	–	**69,195**	–	–	**69,195**
Amounts due to group companies	**10,967**	–	–	–	–	**20,389**	–	–	**31,356**
Other liabilities	–	–	–	–	–	**53,835**	–	–	**53,835**
Subordinated liabilities	–	–	–	–	–	**16,353**	–	–	**16,353**
Preference shares	–	–	–	–	–	**76,464**	–	–	**76,464**
Total financial liabilities	**381,360**	**36,554**	–	–	–	**2,493,428**	**493**	**318**	**2,912,153**

8 Financial Assets and Liabilities *(continued)*

Group

	At 31 December 2005								
	Held for trading	*Designated at fair value*	*Held-to-maturity securities*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
ASSETS									
Cash and short-term funds	–	–	–	343,738	105,452	53,540	–	–	502,730
Items in the course of collection from other banks	–	–	–	–	–	17,782	–	–	17,782
Placings with banks maturing after one month	–	–	–	69,554	–	–	–	–	69,554
Certificates of deposit	–	–	2,716	–	51,115	–	–	–	53,831
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	97,344	–	–	97,344
Trading assets	215,681	–	–	–	–	–	–	–	215,681
Financial assets designated at fair value	–	37,073	–	–	–	–	–	–	37,073
Derivatives	69,724	–	–	–	–	–	658	1,657	72,039
Advances to customers	–	–	–	999,326	–	–	–	–	999,326
Financial investments	–	–	28,102	–	366,395	–	–	–	394,497
Amounts due from group companies	19,333	–	–	–	–	81,840	–	–	101,173
Other assets	–	–	–	–	–	41,873	–	–	41,873
Total financial assets	304,738	37,073	30,818	1,412,618	522,962	292,379	658	1,657	2,602,903
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	97,344	–	–	97,344
Items in the course of transmission to other banks	–	–	–	–	–	20,927	–	–	20,927
Deposits by banks	–	–	–	–	–	83,802	–	–	83,802
Customer accounts	–	–	–	–	–	1,735,110	–	–	1,735,110
Trading liabilities	250,198	–	–	–	–	–	–	–	250,198
Financial liabilities designated at fair value	–	33,291	–	–	–	–	–	–	33,291
Derivatives	70,933	–	–	–	–	–	437	639	72,009
Debt securities in issue	–	–	–	–	–	61,468	–	–	61,468
Amounts due to group companies	1,326	–	–	–	–	23,451	–	–	24,777
Other liabilities	–	–	–	–	–	44,439	–	–	44,439
Subordinated liabilities	–	–	–	–	–	12,561	–	–	12,561
Preference shares	–	–	–	–	–	71,980	–	–	71,980
Total financial liabilities	322,457	33,291	–	–	–	2,151,082	437	639	2,507,906

8 Financial Assets and Liabilities *(continued)*

Bank

	At 31 December 2006								
	Held for trading	*Designated at fair value*	*Held-to-maturity securities*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
ASSETS									
Cash and short-term funds	–	–	–	**310,646**	**107,606**	**7,924**	–	–	**426,176**
Items in the course of collection from other banks	–	–	–	–	–	**40,434**	–	–	**40,434**
Placings with banks maturing after one month	–	–	–	**79,249**	–	–	–	–	**79,249**
Certificates of deposit	–	–	–	–	**33,907**	–	–	–	**33,907**
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	**102,374**	–	–	**102,374**
Trading assets	**284,057**	–	–	–	–	–	–	–	**284,057**
Financial assets designated at fair value	–	**11,182**	–	–	–	–	–	–	**11,182**
Derivatives	**94,262**	–	–	–	–	–	**396**	**3,176**	**97,834**
Advances to customers	–	–	–	**686,468**	–	–	–	–	**686,468**
Financial investments	–	–	–	–	**243,223**	–	–	–	**243,223**
Amounts due from group companies	**37,941**	–	–	–	**2,022**	**129,154**	–	–	**169,117**
Other assets	–	–	–	–	–	**42,808**	–	–	**42,808**
Total financial assets	**416,260**	**11,182**	–	**1,076,363**	**386,758**	**322,694**	**396**	**3,176**	**2,216,829**
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	**102,374**	–	–	**102,374**
Items in the course of transmission to other banks	–	–	–	–	–	**50,618**	–	–	**50,618**
Deposits by banks	–	–	–	–	–	**90,787**	–	–	**90,787**
Customer accounts	–	–	–	–	–	**1,423,519**	–	–	**1,423,519**
Trading liabilities	**182,870**	–	–	–	–	–	–	–	**182,870**
Financial liabilities designated at fair value	–	**2,838**	–	–	–	–	–	–	**2,838**
Derivatives	**98,598**	–	–	–	–	–	**411**	**161**	**99,170**
Debt securities in issue	–	–	–	–	–	**34,494**	–	–	**34,494**
Amounts due to group companies	**20,975**	–	–	–	–	**26,626**	–	–	**47,601**
Other liabilities	–	–	–	–	–	**43,215**	–	–	**43,215**
Subordinated liabilities	–	–	–	–	–	**9,721**	–	–	**9,721**
Preference shares	–	–	–	–	–	**76,464**	–	–	**76,464**
Total financial liabilities	**302,443**	**2,838**	–	–	–	**1,857,818**	**411**	**161**	**2,163,671**

8 Financial Assets and Liabilities *(continued)*

Bank

	At 31 December 2005								
	Held for trading	*Designated at fair value*	*Held-to-maturity securities*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
ASSETS									
Cash and short-term funds	–	–	–	280,642	100,593	48,894	–	–	430,129
Items in the course of collection from other banks	–	–	–	–	–	9,705	–	–	9,705
Placings with banks maturing after one month	–	–	–	53,205	–	–	–	–	53,205
Certificates of deposit	–	–	–	–	23,001	–	–	–	23,001
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	97,344	–	–	97,344
Trading assets	173,169	–	–	–	–	–	–	–	173,169
Financial assets designated at fair value	–	8,755	–	–	–	–	–	–	8,755
Derivatives	68,572	–	–	–	–	–	407	1,349	70,328
Advances to customers	–	–	–	664,645	–	–	–	–	664,645
Financial investments	–	–	–	–	196,684	–	–	–	196,684
Amounts due from group companies	21,151	–	–	–	–	98,826	–	–	119,977
Other assets	–	–	–	–	–	33,936	–	–	33,936
Total financial assets	262,892	8,755	–	998,492	320,278	288,705	407	1,349	1,880,878
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	97,344	–	–	97,344
Items in the course of transmission to other banks	–	–	–	–	–	14,317	–	–	14,317
Deposits by banks	–	–	–	–	–	75,674	–	–	75,674
Customer accounts	–	–	–	–	–	1,247,079	–	–	1,247,079
Trading liabilities	175,127	–	–	–	–	–	–	–	175,127
Financial liabilities designated at fair value	–	1,959	–	–	–	–	–	–	1,959
Derivatives	70,812	–	–	–	–	–	274	324	71,410
Debt securities in issue	–	–	–	–	–	21,267	–	–	21,267
Amounts due to group companies	11,488	–	–	–	–	30,931	–	–	42,419
Other liabilities	–	–	–	–	–	36,018	–	–	36,018
Subordinated liabilities	–	–	–	–	–	9,703	–	–	9,703
Preference shares	–	–	–	–	–	71,980	–	–	71,980
Total financial liabilities	257,427	1,959	–	–	–	1,604,313	274	324	1,864,297

9 Cash and short-term funds

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Cash in hand and current balances with banks	**30,990**	31,230	**19,629**	21,533
Balances with central banks	**17,043**	55,652	**14,777**	54,849
Placings with banks with remaining maturity of one month or less	**361,267**	310,396	**284,164**	253,154
Treasury bills	**108,722**	105,452	**107,606**	100,593
	518,022	502,730	**426,176**	430,129

Deposits required by overseas government regulations included in cash and short-term funds and placings with banks maturing after one month (note 10) are as follows:

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Balances with banks and central banks	**19,177**	14,036	**18,374**	13,533
Treasury bills	**314**	427	**236**	351
	19,491	14,463	**18,610**	13,884

Treasury bills are analysed as follows:

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Treasury bills – available-for-sale				
– which may be repledged or resold by counterparties	**25**	236	**25**	142
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**108,697**	105,216	**107,581**	100,451
	108,722	105,452	**107,606**	100,593

Treasury bills held for trading are included under 'Trading assets'. All treasury bills are unlisted.

10 Placings with banks maturing after one month

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Gross placings with banks maturing after one month	**104,037**	69,554	**79,249**	53,205
Fair value	**104,069**	69,545	**79,283**	53,198

There were no rescheduled placings included in the above table. Details of overdue placings are included in note 51.

Notes on the Financial Statements (continued)

11 Certificates of deposit

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Held-to-maturity – at amortised cost	**2,912**	2,716	**–**	–
Available-for-sale	**70,288**	51,115	**33,907**	23,001
	73,200	53,831	**33,907**	23,001
Held-to-maturity – fair value	**2,941**	2,950	**–**	–

Certificates of deposit held are largely unlisted.

There was no disposal of held-to-maturity certificates of deposit during the year.

12 Hong Kong SAR currency notes in circulation

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

13 Trading assets

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Trading assets				
– which may be repledged or resold by counterparties	**10,599**	12,550	**469**	234
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**328,193**	203,131	**283,588**	172,935
	338,792	215,681	**284,057**	173,169

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**140,252**	108,687	**103,565**	80,246
Equity shares	**23,101**	22,677	**20,816**	22,008
Treasury bills	**152,816**	69,880	**146,744**	67,286
Other	**22,623**	14,437	**12,932**	3,629
	338,792	215,681	**284,057**	173,169

All treasury bills are unlisted.

13 Trading assets *(continued)*

a *Debt securities*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**24,189**	13,606	**21,350**	12,839
– listed outside Hong Kong	**36,428**	29,400	**28,537**	25,761
	60,617	43,006	**49,887**	38,600
Unlisted	**79,635**	65,681	**53,678**	41,646
	140,252	108,687	**103,565**	80,246
Issued by public bodies				
– central governments and central banks	**70,963**	48,387	**49,046**	28,778
– other public sector entities	**5,392**	5,266	**4,104**	3,778
	76,355	53,653	**53,150**	32,556
Issued by other bodies				
– banks	**26,937**	15,234	**17,257**	11,457
– corporate entities	**36,960**	39,800	**33,158**	36,233
	140,252	108,687	**103,565**	80,246

b *Equity shares*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**7,459**	2,281	**7,443**	2,264
– listed outside Hong Kong	**6,529**	9,351	**6,529**	9,330
	13,988	11,632	**13,972**	11,594
Unlisted	**9,113**	11,045	**6,844**	10,414
	23,101	22,677	**20,816**	22,008
Issued by other bodies				
– banks	**2,880**	1,081	**2,880**	1,081
– corporate entities	**20,221**	21,596	**17,936**	20,927
	23,101	22,677	**20,816**	22,008

14 Financial assets designated at fair value

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**22,939**	15,070	**10,766**	5,166
Equity shares	**27,159**	18,320	**–**	–
Treasury bills	**–**	94	**–**	–
Other	**416**	3,589	**416**	3,589
	50,514	37,073	**11,182**	8,755

All treasury bills are unlisted.

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

a *Debt securities*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK\$m	HK\$m	**HK\$m**	HK\$m
Listed				
– listed in Hong Kong	**1,687**	1,220	**978**	1,014
– listed outside Hong Kong	**2,422**	3,226	**1,297**	1,074
	4,109	4,446	**2,275**	2,088
Unlisted	**18,830**	10,624	**8,491**	3,078
	22,939	15,070	**10,766**	5,166

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK\$m	HK\$m	**HK\$m**	HK\$m
Issued by public bodies				
– central governments and central banks	**4,247**	3,514	**1,527**	1,634
– other public sector entities	**1,183**	1,039	**357**	493
	5,430	4,553	**1,884**	2,127
Issued by other bodies				
– banks	**13,571**	7,410	**6,804**	1,437
– corporate entities	**3,938**	3,107	**2,078**	1,602
	22,939	15,070	**10,766**	5,166

b *Equity shares*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK\$m	HK\$m	**HK\$m**	HK\$m
Listed				
– listed in Hong Kong	**6,609**	6,269	**–**	–
– listed outside Hong Kong	**13,910**	9,107	**–**	–
	20,519	15,376	**–**	–
Unlisted	**6,640**	2,944	**–**	–
	27,159	18,320	**–**	–
Issued by other bodies				
– banks	**3**	26	**–**	–
– corporate entities	**27,156**	18,294	**–**	–
	27,159	18,320	**–**	–

15 Derivatives

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

Derivatives enable users to increase, reduce or alter exposure to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks.

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.

15 Derivatives *(continued)*

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 note 3j.

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.

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

	2006		2005	
	Group	*Bank*	*Group*	*Bank*
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**4,526,572**	**4,226,254**	3,420,841	3,237,954
Interest rate	**7,469,197**	**7,401,165**	5,300,958	5,179,116
Equities	**136,281**	**145,726**	63,487	72,670
Credit derivatives	**401,070**	**400,027**	183,424	183,366
Forward asset purchases and forward forward deposits placed	**2,588**	**2,254**	1,849	1,347
Commodity and other	**17,450**	**17,485**	42,108	42,722
Total derivatives	**12,553,158**	**12,192,911**	9,012,667	8,717,175

Notes on the Financial Statements (continued)

15 Derivatives *(continued)*

(ii) Fair values of outstanding trading derivatives

Group

	2006		2005	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**42,862**	**41,468**	31,074	29,254
Interest rate	**42,389**	**40,599**	36,004	35,739
Equities	**6,351**	**11,734**	1,388	2,570
Credit derivatives	**3,024**	**3,502**	970	2,802
Commodity and other	**121**	**545**	288	568
Total derivatives	**94,747**	**97,848**	69,724	70,933

Bank

	2006		2005	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**42,194**	**41,016**	30,211	28,826
Interest rate	**42,318**	**40,286**	35,709	35,148
Equities	**6,355**	**13,245**	1,395	3,601
Credit derivatives	**3,025**	**3,506**	969	2,802
Commodity and other	**370**	**545**	288	435
Total derivatives	**94,262**	**98,598**	68,572	70,812

(iii) Risk exposure by counterparty type

	2006		2005	
	Group	*Bank*	*Group*	*Bank*
	%	**%**	%	%
Government	**1**	**1**	1	1
Banks	**68**	**68**	66	66
Other financial institutions	**14**	**14**	13	13
Other	**17**	**17**	20	20
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 hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or net investment hedges. These are described under the relevant headings below.

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

	Group		*Bank*	
	Cash flow hedge	**Fair value hedge**	**Cash flow hedge**	**Fair value hedge**
	HK$m	**HK$m**	**HK$m**	**HK$m**
31 December 2006				
Foreign exchange	**2,969**	–	**2,969**	–
Interest rate	**293,773**	**74,955**	**231,667**	**54,378**
Total derivatives	**296,742**	**74,955**	**234,636**	**54,378**

15 Derivatives *(continued)*

	Group		*Bank*	
	Cash flow hedge HK$m	Fair value hedge HK$m	Cash flow hedge HK$m	Fair value hedge HK$m
31 December 2005				
Interest rate	211,220	78,168	161,559	52,229

(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**
31 December 2006				
Interest rate	**672**	**493**	**396**	**411**

	Group		*Bank*	
	Assets HK$m	Liabilities HK$m	Assets HK$m	Liabilities HK$m
31 December 2005				
Interest rate	658	437	407	274

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

	Group		*Bank*	
	Assets	**Liabilities**	**Assets**	**Liabilities**
31 December 2006	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Foreign exchange	–	**107**	–	**107**
Interest rate	**3,748**	**211**	**3,176**	**54**
	3,748	**318**	**3,176**	**161**

	Group		*Bank*	
	Assets HK$m	Liabilities HK$m	Assets HK$m	Liabilities HK$m
31 December 2005				
Interest rate	1,657	639	1,349	324

The cash flows of the above hedging derivatives are expected to affect the income statement for 2007.

c *Credit equivalent amounts and risk-weighted amounts*

The tables below give the nominal contract amounts, credit equivalent amounts and risk-weighted amounts of derivatives. The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Third Schedule of the Hong Kong Banking Ordinance on capital adequacy and depend on the status of the counterparty and the maturity characteristics. The risk weights used range from 0% to 100%. The group has executed close-out netting agreements with certain counterparties, which allow for positive and negative mark-to-market values on different transactions to be offset and settled by a single payment in the event of default by either party. These have been taken into account in calculating total risk weighted assets.

Derivatives arise from futures, forward, swap and option transactions undertaken by the group in the foreign exchange, interest rate, equity, credit and commodity markets. The contract amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Notes on the Financial Statements (continued)

15 Derivatives *(continued)*

Group

	2006			2005		
	Contract amount	*Credit equivalent amount*	*Risk-weighted amount*	*Contract amount*	*Credit equivalent amount*	*Risk-weighted amount*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Exchange rate contracts:						
Spot and forward foreign exchange	**3,267,333**	**52,122**	**13,334**	2,536,795	36,655	9,753
Swap and other exchange rate contracts	**1,262,208**	**56,377**	**16,868**	884,046	41,124	12,481
	4,529,541	**108,499**	**30,202**	3,420,841	77,779	22,234
Interest rate contracts:						
Interest rate swaps	**6,919,779**	**69,936**	**17,832**	4,775,236	55,580	14,442
Other interest rate contracts	**918,146**	**5,641**	**1,808**	815,110	4,159	1,340
	7,837,925	**75,577**	**19,640**	5,590,346	59,739	15,782
Forward asset purchases and forward forward deposits placed	**2,588**	**2,588**	**2,463**	1,849	1,849	775
Other derivative contracts	**554,801**	**27,935**	**9,041**	289,019	15,885	5,649
	557,389	**30,523**	**11,504**	290,868	17,734	6,424
Impact of counterparty netting agreements on derivatives exposure	**–**	**(67,516)**	**(14,352)**	–	(55,354)	(11,915)

Bank

	2006			2005		
	Contract amount	*Credit equivalent amount*	*Risk-weighted amount*	*Contract amount*	*Credit equivalent amount*	*Risk-weighted amount*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Exchange rate contracts:						
Spot and forward foreign exchange	**3,037,561**	**49,672**	**12,755**	2,368,618	35,266	9,421
Swap and other exchange rate contracts	**1,191,662**	**55,908**	**16,758**	869,336	40,931	12,441
	4,229,223	**105,580**	**29,513**	3,237,954	76,197	21,862
Interest rate contracts:						
Interest rate swaps	**6,749,847**	**68,534**	**17,551**	4,599,457	54,440	14,234
Other interest rate contracts	**937,363**	**5,662**	**1,814**	793,447	4,202	1,348
	7,687,210	**74,196**	**19,365**	5,392,904	58,642	15,582
Forward asset purchases and forward forward deposits placed	**2,254**	**2,254**	**2,254**	1,347	1,347	417
Other derivative contracts	**563,238**	**28,396**	**9,312**	298,758	16,452	5,934
	565,492	**30,650**	**11,566**	300,105	17,799	6,351
Impact of counterparty netting agreements on derivatives exposure	**–**	**(67,516)**	**(14,352)**	–	(55,354)	(11,915)

15 Derivatives *(continued)*

d *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 difference yet to be recognised in the income statement at the beginning and end of the year with a reconciliation of the changes of the balance during the year.

Group

	2006	2005
	HK$m	HK$m
Balance at 1 January	**103**	64
Deferrals on new transactions	**93**	86
Reduction due to amortisation	**(4)**	(17)
Reduction due to redemption/sales/transfers/improved observability	**(88)**	(14)
Exchange differences and others	**4**	(16)
Balance at 31 December	**108**	103

Bank

	2006	2005
	HK$m	HK$m
Balance at 1 January	**103**	64
Deferrals on new transactions	**93**	86
Reduction due to amortisation	**(4)**	(17)
Reduction due to redemption/sales/transfers/improved observability	**(88)**	(14)
Exchange differences and others	**6**	(16)
Balance at 31 December	**110**	103

16 Advances to customers

a *Advances to customers*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers	**1,050,625**	1,005,902	**692,170**	669,993
Impairment allowances (note 17a)	**(6,843)**	(6,576)	**(5,702)**	(5,348)
	1,043,782	999,326	**686,468**	664,645
Fair value	**1,045,594**	997,439	**686,392**	663,926

Included in advances to customers are:

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Trade bills	**53,559**	42,931	**45,252**	36,572
Individually assessed impairment allowances	**(104)**	(236)	**(96)**	(227)
	53,455	42,695	**45,156**	36,345

Notes on the Financial Statements (continued)

16 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 categories used by the HSBC Group, including The Hongkong and Shanghai Banking Corporation Limited and its subsidiary companies, to manage associated risks.

Group

2006	*Hong Kong*	*Rest of Asia-Pacific*	*Americas/ Europe*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Residential mortgages	**191,522**	**112,900**	**5**	**304,427**
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**31,708**	**–**	**–**	**31,708**
Credit card advances	**31,315**	**19,999**	**–**	**51,314**
Other personal	**30,778**	**35,908**	**1**	**66,687**
Total personal	**285,323**	**168,807**	**6**	**454,136**
Commercial, industrial and international trade	**130,994**	**133,560**	**–**	**264,554**
Commercial real estate	**94,706**	**36,052**	**–**	**130,758**
Other property-related lending	**53,832**	**15,627**	**–**	**69,459**
Government	**4,283**	**6,727**	**–**	**11,010**
Other commercial	**43,186**	**38,781**	**–**	**81,967**
Total corporate and commercial	**327,001**	**230,747**	**–**	**557,748**
Non-bank financial institutions	**18,138**	**16,471**	**–**	**34,609**
Settlement accounts	**3,774**	**358**	**–**	**4,132**
Total financial	**21,912**	**16,829**	**–**	**38,741**
Gross advances to customers	**634,236**	**416,383**	**6**	**1,050,625**
Impairment allowances	**(2,838)**	**(4,005)**	**–**	**(6,843)**
Net advances to customers	**631,398**	**412,378**	**6**	**1,043,782**

2005	*Hong Kong*	*Rest of Asia-Pacific*	*Americas/ Europe*	*Total*
	HK$m	HK$m	HK$m	HK$m
Residential mortgages	182,257	117,211	4	299,472
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	36,291	–	–	36,291
Credit card advances	29,882	16,539	–	46,421
Other personal	27,480	31,316	1	58,797
Total personal	275,910	165,066	5	440,981
Commercial, industrial and international trade	129,774	110,668	–	240,442
Commercial real estate	97,364	32,615	–	129,979
Other property-related lending	47,661	17,340	–	65,001
Government	2,347	5,891	–	8,238
Other commercial	53,681	37,851	–	91,532
Total corporate and commercial	330,827	204,365	–	535,192
Non-bank financial institutions	15,246	11,987	–	27,233
Settlement accounts	2,173	323	–	2,496
Total financial	17,419	12,310	–	29,729
Gross advances to customers	624,156	381,741	5	1,005,902
Impairment allowances	(3,092)	(3,484)	–	(6,576)
Net advances to customers	621,064	378,257	5	999,326

16 Advances to customers *(continued)*

Bank

2006	*Hong Kong*	*Rest of Asia-Pacific*	*Americas/ Europe*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Residential mortgages	**97,174**	**84,551**	**–**	**181,725**
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**11,629**	**–**	**–**	**11,629**
Credit card advances	**21,867**	**16,899**	**–**	**38,766**
Other personal	**19,816**	**32,205**	**1**	**52,022**
Total personal	**150,486**	**133,655**	**1**	**284,142**
Commercial, industrial and international trade	**82,319**	**118,474**	**–**	**200,793**
Commercial real estate	**61,749**	**26,765**	**–**	**88,514**
Other property-related lending	**17,420**	**12,355**	**–**	**29,775**
Government	**1,436**	**6,322**	**–**	**7,758**
Other commercial	**20,486**	**32,823**	**–**	**53,309**
Total corporate and commercial	**183,410**	**196,739**	**–**	**380,149**
Non-bank financial institutions	**15,849**	**11,682**	**–**	**27,531**
Settlement accounts	**–**	**348**	**–**	**348**
Total financial	**15,849**	**12,030**	**–**	**27,879**
Gross advances to customers	**349,745**	**342,424**	**1**	**692,170**
Impairment allowances	**(1,847)**	**(3,855)**	**–**	**(5,702)**
Net advances to customers	**347,898**	**338,569**	**1**	**686,468**

2005	*Hong Kong*	*Rest of Asia-Pacific*	*Americas/ Europe*	*Total*
	HK$m	HK$m	HK$m	HK$m
Residential mortgages	93,797	82,616	–	176,413
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	13,412	–	–	13,412
Credit card advances	22,147	14,290	–	36,437
Other personal	18,916	26,474	1	45,391
Total personal	148,272	123,380	1	271,653
Commercial, industrial and international trade	87,869	101,320	–	189,189
Commercial real estate	66,019	24,729	–	90,748
Other property-related lending	14,408	13,235	–	27,643
Government	1,112	5,818	–	6,930
Other commercial	27,359	31,534	–	58,893
Total corporate and commercial	196,767	176,636	–	373,403
Non-bank financial institutions	13,873	9,795	–	23,668
Settlement accounts	1,092	177	–	1,269
Total financial	14,965	9,972	–	24,937
Gross advances to customers	360,004	309,988	1	669,993
Impairment allowances	(1,991)	(3,357)	–	(5,348)
Net advances to customers	358,013	306,631	1	664,645

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

Notes on the Financial Statements (continued)

16 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 subsidiary companies in Hong Kong.

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial				
Property development	**46,352**	41,141	**28,301**	24,695
Property investment	**99,580**	104,214	**51,442**	58,211
Financial concerns	**10,136**	12,667	**7,875**	11,696
Stockbrokers	**964**	1,094	**730**	873
Wholesale and retail trade	**36,101**	34,256	**29,692**	28,694
Manufacturing	**17,331**	17,847	**9,595**	10,086
Transport and transport equipment	**27,408**	31,202	**16,162**	19,178
Others	**43,612**	44,697	**18,885**	21,505
	281,484	287,118	**162,682**	174,938
Individuals				
Advances for the purchase of flats under the Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**31,708**	36,291	**11,629**	13,412
Advances for the purchase of other residential properties	**171,014**	165,148	**87,399**	83,831
Credit card advances	**31,315**	29,882	**21,867**	22,147
Others	**26,966**	23,826	**16,294**	15,535
	261,003	255,147	**137,189**	134,925
Gross advances to customers for use in Hong Kong	**542,487**	542,265	**299,871**	309,863
Trade finance	**56,121**	49,902	**36,437**	34,028
Gross advances to customers for use outside Hong Kong made by branches of the Bank and subsidiary companies in Hong Kong	**35,628**	31,989	**13,437**	16,113
Gross advances to customers made by branches of the Bank and subsidiary companies in Hong Kong	**634,236**	624,156	**349,745**	360,004
Gross advances to customers made by branches of the Bank and subsidiary companies outside Hong Kong				
– rest of Asia-Pacific	**416,383**	381,741	**342,424**	309,988
– Americas/Europe	**6**	5	**1**	1
Gross advances to customers	**1,050,625**	1,005,902	**692,170**	669,993

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 subsidiary companies, as disclosed in note 16b.

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

16 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

	2006			2005		
	Present value of the minimum lease payments	*Unearned future finance income*	*Total minimum lease payments*	*Present Value of the minimum lease payments*	*Unearned future finance income*	*Total minimum lease payments*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Amounts receivable						
– Within one year	**5,647**	**1,423**	**7,070**	5,324	1,415	6,739
– After one year but within five years	**12,941**	**3,325**	**16,266**	13,545	3,938	17,483
– After five years	**11,854**	**4,294**	**16,148**	14,648	5,023	19,671
	30,442	**9,042**	**39,484**	33,517	10,376	43,893
Impairment allowances	**(70)**			(44)		
Net investment in finance leases and hire purchase contracts	**30,372**			33,473		

Bank

	2006			2005		
	Present value of the minimum lease payments	*Unearned future finance income*	*Total minimum lease payments*	*Present Value of the minimum lease payments*	*Unearned future finance income*	*Total minimum lease payments*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Amounts receivable						
– Within one year	**4,062**	**832**	**4,894**	3,996	825	4,821
– After one year but within five years	**9,224**	**1,909**	**11,133**	9,877	1,947	11,824
– After five years	**6,691**	**2,015**	**8,706**	7,085	1,943	9,028
	19,977	**4,756**	**24,733**	20,958	4,715	25,673
Impairment allowances	**(22)**			(11)		
Net investment in finance leases and hire purchase contracts	**19,955**			20,947		

Notes on the Financial Statements (continued)

17 Impairment allowances against advances to customers

a *Impairment allowances against advances to customers*

Group

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2006	**HK$m**	**HK$m**	**HK$m**
At 1 January	**2,976**	**3,600**	**6,576**
Amounts written off	**(1,196)**	**(3,830)**	**(5,026)**
Recoveries of advances written off in previous years	**212**	**498**	**710**
Net charge to income statement (note 4k)	**233**	**4,468**	**4,701**
Unwinding of discount of loan impairment	**(85)**	**(111)**	**(196)**
Exchange and other adjustments	**(22)**	**100**	**78**
At 31 December	**2,118**	**4,725**	**6,843**

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2005	HK$m	HK$m	HK$m
At 1 January	4,730	3,179	7,909
Amounts written off	(1,982)	(1,948)	(3,930)
Recoveries of advances written off in previous years	267	395	662
Net charge to income statement (note 4k)	107	1,961	2,068
Unwinding of discount of loan impairment	(81)	–	(81)
Exchange and other adjustments	(65)	13	(52)
At 31 December	2,976	3,600	6,576

Bank

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2006	**HK$m**	**HK$m**	**HK$m**
At 1 January	**2,330**	**3,018**	**5,348**
Amounts written off	**(943)**	**(3,432)**	**(4,375)**
Recoveries of advances written off in previous years	**185**	**415**	**600**
Net charge to income statement	**145**	**4,116**	**4,261**
Unwinding of discount of loan impairment	**(59)**	**(111)**	**(170)**
Exchange and other adjustments	**(42)**	**80**	**38**
At 31 December	**1,616**	**4,086**	**5,702**

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2005	HK$m	HK$m	HK$m
At 1 January	3,877	2,791	6,668
Amounts written off	(1,390)	(1,720)	(3,110)
Recoveries of advances written off in previous years	194	337	531
Net (release)/charge to income statement	(251)	1,592	1,341
Unwinding of discount of loan impairment	(61)	–	(61)
Exchange and other adjustments	(39)	18	(21)
At 31 December	2,330	3,018	5,348

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

b *Impaired advances to customers and allowances*

Group

2006	*Hong Kong* **HK$m**	*Rest of Asia-Pacific* **HK$m**	*Americas/ Europe* **HK$m**	*Total* **HK$m**
Impairment allowance charge	**1,228**	**3,473**	**–**	**4,701**
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	**3,530**	**5,071**	**–**	**8,601**
Individually assessed allowances	**(1,016)**	**(1,102)**	**–**	**(2,118)**
	2,514	**3,969**	**–**	**6,483**
Individually assessed allowances as a percentage of gross impaired advances	**28.8%**	**21.7%**	**–**	**24.6%**
Gross impaired advances as a percentage of gross advances to customers	**0.6%**	**1.2%**	**–**	**0.8%**

2005	*Hong Kong* HK$m	*Rest of Asia-Pacific* HK$m	*Americas/ Europe* HK$m	*Total* HK$m
Impairment allowance charge/(release)	1,156	924	(12)	2,068
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	3,920	3,079	–	6,999
Individually assessed allowances	(1,345)	(1,631)	–	(2,976)
	2,575	1,448	–	4,023
Individually assessed allowances as a percentage of gross impaired advances	34.3%	53.0%	–	42.5%
Gross impaired advances as a percentage of gross advances to customers	0.6%	0.8%	–	0.7%

Notes on the Financial Statements (continued)

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

Bank

2006	*Hong Kong* **HK$m**	*Rest of Asia-Pacific* **HK$m**	*Americas/ Europe* **HK$m**	*Total* **HK$m**
Impairment allowance charge	**976**	**3,285**	**–**	**4,261**
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	**2,058**	**4,770**	**–**	**6,828**
Individually assessed allowances	**(544)**	**(1,072)**	**–**	**(1,616)**
	1,514	**3,698**	**–**	**5,212**
Individually assessed allowances as a percentage of gross impaired advances	**26.4%**	**22.5%**	**–**	**23.7%**
Gross impaired advances as a percentage of gross advances to customers	**0.6%**	**1.4%**	**–**	**1.0%**

2005	*Hong Kong* HK$m	*Rest of Asia-Pacific* HK$m	*Americas/ Europe* HK$m	*Total* HK$m
Impairment allowance charge/(release)	538	815	(12)	1,341
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	2,402	2,794	–	5,196
Individually assessed allowances	(754)	(1,576)	–	(2,330)
	1,648	1,218	–	2,866
Individually assessed allowances as a percentage of gross impaired advances	31.4%	56.4%	–	44.8%
Gross impaired advances as a percentage of gross advances to customers	0.7%	0.9%	–	0.8%

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.

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

c *Overdue advances to customers*

Group

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
2006	**HK$m**	**%**	**HK$m**	**%**	**HK$m**	**%**
Gross advances to customers which are overdue with respect to either principal or interest for periods of						
– six months or less but over three months	**938**	**0.1**	**1,287**	**0.3**	**2,225**	**0.2**
– one year or less but over six months	**384**	**0.1**	**595**	**0.1**	**979**	**0.1**
– over one year	**1,238**	**0.2**	**859**	**0.2**	**2,097**	**0.2**
	2,560	**0.4**	**2,741**	**0.6**	**5,301**	**0.5**

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
2005	HK$m	%	HK$m	%	HK$m	%
Gross advances to customers which are overdue with respect to either principal or interest for periods of						
– six months or less but over three months	1,073	0.2	891	0.2	1,964	0.2
– one year or less but over six months	272	–	430	0.1	702	0.1
– over one year	1,053	0.2	1,071	0.3	2,124	0.2
	2,398	0.4	2,392	0.6	4,790	0.5

Notes on the Financial Statements (continued)

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

Bank

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
2006	**HK$m**	**%**	**HK$m**	**%**	**HK$m**	**%**
Gross advances to customers which are overdue with respect to either principal or interest for periods of						
– six months or less but over three months	**434**	**0.1**	**1,068**	**0.3**	**1,502**	**0.2**
– one year or less but over six months	**121**	**–**	**494**	**0.2**	**615**	**0.1**
– over one year	**998**	**0.3**	**775**	**0.2**	**1,773**	**0.3**
	1,553	**0.4**	**2,337**	**0.7**	**3,890**	**0.6**

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
2005	HK$m	%	HK$m	%	HK$m	%
Gross advances to customers which are overdue with respect to either principal or interest for periods of						
– six months or less but over three months	591	0.2	675	0.2	1,266	0.2
– one year or less but over six months	62	–	342	0.1	404	–
– over one year	816	0.2	981	0.3	1,797	0.3
	1,469	0.4	1,998	0.6	3,467	0.5

d *Rescheduled advances to customers*

Group

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
	HK$m	**%**	**HK$m**	**%**	**HK$m**	**%**
2006	**1,730**	**0.3**	**2,307**	**0.6**	**4,037**	**0.4**
2005	1,941	0.3	623	0.2	2,564	0.3

Bank

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
	HK$m	**%**	**HK$m**	**%**	**HK$m**	**%**
2006	**1,373**	**0.4**	**2,293**	**0.7**	**3,666**	**0.5**
2005	1,580	0.4	602	0.2	2,182	0.3

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

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 17c).

18 Financial investments

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Financial investments				
– which may be repledged or resold by counterparties	**124**	1,049	**124**	1,049
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**484,717**	393,448	**243,099**	195,635
	484,841	394,497	**243,223**	196,684

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Debt securities				
– available-for-sale	**404,853**	350,624	**208,442**	184,325
– held-to-maturity	**40,407**	28,102	**–**	–
Equity shares				
– available-for-sale	**39,581**	15,771	**34,781**	12,359
	484,841	394,497	**243,223**	196,684

Notes on the Financial Statements (continued)

18 Financial investments *(continued)*

a *Held-to-maturity debt securities*

Group

	Book value		*Fair value*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**392**	713	**400**	775
– listed outside Hong Kong	**3,286**	3,274	**3,322**	3,344
	3,678	3,987	**3,722**	4,119
Unlisted	**36,729**	24,115	**37,428**	23,690
	40,407	28,102	**41,150**	27,809

	Book value		*Fair value*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**1,195**	1,178	**1,207**	1,215
– other public sector entities	**1,790**	1,593	**1,874**	1,729
	2,985	2,771	**3,081**	2,944
Issued by other bodies				
– banks	**35,344**	23,550	**35,953**	23,145
– corporate entities	**2,078**	1,781	**2,116**	1,720
	40,407	28,102	**41,150**	27,809

b *Available-for-sale debt securities*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**5,652**	6,821	**1,951**	3,855
– listed outside Hong Kong	**61,395**	74,609	**59,499**	72,872
	67,047	81,430	**61,450**	76,727
Unlisted	**337,806**	269,194	**146,992**	107,598
	404,853	350,624	**208,442**	184,325

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**41,988**	61,705	**34,394**	47,940
– other public sector entities	**16,776**	20,873	**10,183**	14,290
	58,764	82,578	**44,577**	62,230
Issued by other bodies				
– banks	**310,976**	231,476	**146,624**	102,019
– corporate entities	**35,113**	36,570	**17,241**	20,076
	404,853	350,624	**208,442**	184,325

18 Financial investments *(continued)*

c *Available-for-sale equity shares*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**29,210**	9,930	**26,523**	8,880
– listed outside Hong Kong	**2,601**	2,914	**1,127**	923
	31,811	12,844	**27,650**	9,803
Unlisted	**7,770**	2,927	**7,131**	2,556
	39,581	15,771	**34,781**	12,359

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Issued by other bodies				
– banks	**4,877**	3,388	**3,523**	1,581
– corporate entities	**34,704**	12,383	**31,258**	10,778
	39,581	15,771	**34,781**	12,359

19 Investments in subsidiary companies

	Bank	
	2006	2005
	HK$m	HK$m
Investment in subsidiary companies – at cost		
Unlisted investments	**6,963**	5,383
Listed investment	**865**	865
	7,828	6,248

The principal subsidiary companies of the Bank are:

	Place of incorporation	*Principal activity*	*Issued equity capital*	*Group's interest in equity capital*
Hang Seng Bank Limited	Hong Kong SAR	Banking	HK$9,559m	62.14%
HSBC Bank Australia Limited*	Australia	Banking	A$811m	100%
HSBC Insurance (Asia) Limited*	Hong Kong SAR	Insurance	HK$125m	100%
HSBC Life (International) Limited*	Bermuda	Retirement benefits and life assurance	HK$327m	100%

* *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 the Hong Kong SAR.

All of the above companies are controlled subsidiaries and have been consolidated in the Group 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 certain shareholder loans or cash dividends.

Notes on the Financial Statements (continued)

20 Investments in associates and joint venture

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Unlisted investments	**–**	–	**520**	254
Listed investment	**–**	–	**16,988**	16,988
Share of net assets	**21,361**	18,799	**–**	–
Goodwill	**2,370**	2,303	**–**	–
Intangible assets	**2,691**	2,924	**–**	–
Deferred tax on intangible assets	**(888)**	(965)	**–**	–
	25,534	23,061	**17,508**	17,242

a *Principal associates*

The principal associated companies of the group are:

	Place of incorporation	*Principal activity*	*Issued equity capital*	*Group's interest in equity capital*
Listed				
Bank of Communications Limited	People's Republic of China	Banking	RMB45,804m	19.9%
Unlisted				
Industrial Bank Co., Ltd.*	People's Republic of China	Banking	RMB3,999m	15.98%
Barrowgate Limited*	Hong Kong SAR	Property investment	1	24.64%

1 *Issued equity capital is less than HK$1 million*
* *Held indirectly*

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

Shareholdings in associated companies include listed investments of HK$16,988 million *(2005: HK$16,988 million)*. At the balance sheet date, the fair value of these investments, based on quoted market prices was HK$86,046 million *(2005: HK$32,130 million)*.

Hang Seng Bank Limited holds a 15.98 per cent stake in Industrial Bank Co., Ltd. and The Hongkong and Shanghai Banking Corporation Limited holds a 19.9 per cent interest in Bank of Communications Limited. 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, is assisting in the development of financial and operating policies. In respect of Bank of Communications Limited, 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 Limited, The Hongkong and Shanghai Banking Corporation Limited has representation on the senior executive remuneration committee and on the audit committee.

20 Investments in associates and joint venture *(continued)*

In respect of the year ended 31 December 2006, Bank of Communications Limited and Industrial Bank Co., Ltd were included in these financial statements based on financial statements drawn up to 30 September 2006, but taking into account any changes in the subsequent period from 1 October 2006 to 31 December 2006 that would materially affect the results. 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 must be no greater than three months.

Interest in associates includes intangible assets with respect to customer relationships and brand name which are amortised over a period of 10 years.

On 5 February 2007, Industrial Bank Co., Ltd. made an initial public offering of 1,001 million new shares for a total consideration of RMB16.0 billion. Hang Seng has not subscribed for any additional shares as part of this initial public offering and, as a result, its interest in the equity of Industrial Bank Co., Ltd. decreased from 15.98 per cent to 12.78 per cent. While Hang Seng's interest has reduced, the assets of Industrial Bank Co., Ltd. have substantially increased as a result of this issue. Consequently, it is expected that this transaction would result in an increase of about RMB1.5 billion in Hang Seng's share of the underlying net assets of Industrial Bank Co., Ltd.

The decrease of Hang Seng's interest in the equity of Industrial Bank Co., Ltd. does not affect the influence that Hang Seng has over this associate, as there has been no change in the composition of major shareholdings in Industrial Bank Co., Ltd. or in Hang Seng's representation on the Board of Directors or the executive committee. Hang Seng will continue to have the power to participate in the financial and operating policy decisions of Industrial Bank Co., Ltd., and its investment will continue to be accounted for using the equity method.

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

	Assets	*Liabilities*	*Equity*	*Revenue*	*Expenses*	*Profit*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
2006						
100 per cent	**2,187,855**	**2,079,104**	**108,751**	**53,956**	**38,610**	**15,346**
Group's effective interest[1]	**377,476**	**357,311**	**20,165**	**9,634**	**6,920**	**2,714**
2005						
100 per cent	1,731,782	1,637,177	94,605	40,315	29,333	10,982
Group's effective interest[1]	301,517	283,707	17,810	7,153	5,200	1,953

1 *The group's effective interest is stated net of minority interest.*

At 31 December 2006, the group's share of associates and joint venture's contingent liabilities was HK$73,412 million *(2005: HK$52,518 million)*.

c *Movement in investments in associates and joint venture*

	2006	
	Group	*Bank*
	HK$m	**HK$m**
At 1 January	**23,061**	**17,242**
Additions	**93**	**463**
Retained profits	**2,178**	–
Amortisation of intangible assets (net of deferred tax)	**(223)**	–
Reclassified as held for sale	**(195)**	**(197)**
Exchange and other movements	**620**	–
At 31 December	**25,534**	**17,508**

There is no impairment of investments in associates and joint venture.

Notes on the Financial Statements (continued)

20 Investments in associates and joint venture *(continued)*

d *Amounts due from/to associates and joint venture*

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from associates	**530**	1,722	–	1,330
Amounts due to associates	**1,191**	360	**557**	350
Amounts due from joint venture	**260**	–	**260**	–
Amounts due to joint venture	**338**	–	**338**	–

e *Investment in joint venture*

In 2006, the group transferred part of its credit card merchant acquiring business to a joint venture company set up with Global Payments Inc. The net profit on disposal of the business was HK$391 million. The group holds 44% of the equity capital of the new joint venture company, Global Payments Asia-Pacific Ltd, and in accordance with the company's shareholders agreement, all strategic financial and operating decisions require the unanimous approval of either the Board of Directors or all shareholders. As a result, the group together with the other shareholder, exercise joint control over the company.

Global Payments Asia-Pacific Ltd prepares its financial statements up to 31 May and its principal country of operations is Hong Kong. For the year ended 31 December 2006, the company was equity accounted for based on financial statements made up to 30 November 2006, taking into account changes in the subsequent period from 1 December to 31 December 2006 that would have materially affected its results.

21 Goodwill and intangible assets

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

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Goodwill	**1,997**	1,652	**1,021**	752
The present value of in-force long-term assurance business	**5,841**	4,685	–	–
Other intangible assets	**2,590**	915	**2,339**	819
	10,428	7,252	**3,360**	1,571

21 Goodwill and intangible assets *(continued)*

a *Goodwill*

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Cost				
At 1 January	**1,652**	1,473	**752**	788
Additions	**313**	10	**291**	–
Transfers	**–**	231	**–**	–
Reclassified as held for sale	**(33)**	–	**(33)**	–
Exchange and other movements	**65**	(62)	**11**	(36)
At 31 December	**1,997**	1,652	**1,021**	752
Net book value at 31 December	**1,997**	1,652	**1,021**	752

There was no impairment of goodwill.

Geographical analysis of goodwill

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong	**803**	751	**522**	493
Rest of Asia-Pacific	**1,194**	901	**499**	259
	1,997	1,652	**1,021**	752

During 2006, there was no impairment of goodwill (*2005: HK$nil*). Goodwill is allocated to cash-generating units 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 annually by comparing the present value of the expected future cash flows from a business with the carrying amount of its net assets, including attributable goodwill. The discount rate used to discount future cash flows is based on the cost of capital HSBC allocates to investments in the countries within which the cash-generating units operate.

b *The present value of in-force long-term assurance business ('PVIF')*

(i) PVIF specific assumptions

The following are the key assumptions used in the computation of PVIF for the main insurance operations:

	2006	2005
Risk adjusted discount rate	**11.0%**	11.0%
Expenses inflation	**3.0%**	3.0%
Lapse rate	**3%-15% for the first policy year and 0%-5% for renewal years**	3%-15% for the first policy year and 0%-5% for renewal years

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

	Group	
	2006	2005
	HK$m	HK$m
At 1 January	**4,685**	3,513
Addition from current year new business	**1,593**	1,623
Movement from in-force business	**(469)**	(438)
Exchange and other adjustments	**32**	(13)
At 31 December	**5,841**	4,685

Notes on the Financial Statements (continued)

21 Goodwill and intangible assets *(continued)*

The following table shows the effect on the PVIF for the year then ended of theoretical changes in the main economic assumptions:

	Impact on 2006 results	*Impact on 2005 results*
	HK$m	HK$m
+ 100 basis points shift in risk free rate	**1,018**	700
- 100 basis points shift in risk free rate	**(1,105)**	(776)
+ 100 basis points shift in risk adjusted discount rate	**(287)**	(208)
- 100 basis points shift in risk adjusted discount rate	**326**	229
+ 100 basis points shift in expenses inflation	**(20)**	(16)
- 100 basis points shift in expenses inflation	**18**	14
+ 100 basis points shift in lapse rate	**675**	403
- 100 basis points shift in lapse rate	**(702)**	(427)

c *Other intangible assets*

Group

	Computer software	*Customer/ merchant relationships*	*Other*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Cost				
At 1 January 2006	**1,467**	**179**	**5**	**1,651**
Additions	**1,140**	**866**	**2**	**2,008**
Disposals	**(73)**	**–**	**–**	**(73)**
Exchange and other movements	**26**	**37**	**–**	**63**
At 31 December 2006	**2,560**	**1,082**	**7**	**3,649**
Accumulated amortisation and impairment				
At 1 January 2006	**709**	**24**	**3**	**736**
Amortisation charge for the year	**294**	**49**	**–**	**343**
Disposals	**(42)**	**–**	**–**	**(42)**
Exchange and other movements	**21**	**1**	**–**	**22**
At 31 December 2006	**982**	**74**	**3**	**1,059**
Net book value at 31 December 2006	**1,578**	**1,008**	**4**	**2,590**

21 Goodwill and intangible assets *(continued)*

Group

	Computer software	*Customer/ merchant relationships*	*Other*	*Total*
	HK$m	HK$m	HK$m	HK$m
Cost				
At 1 January 2005	818	119	3	940
Additions	670	–	–	670
Disposals	(17)	–	–	(17)
Transfer	–	60	–	60
Exchange and other movements	(4)	–	2	(2)
At 31 December 2005	1,467	179	5	1,651
Accumulated amortisation and impairment				
At 1 January 2005	594	–	3	597
Amortisation charge for the year	134	24	–	158
Disposals	(16)	–	–	(16)
Exchange and other movements	(3)	–	–	(3)
At 31 December 2005	709	24	3	736
Net book value at 31 December 2005	758	155	2	915

Bank

	Computer software	*Customer/ merchant relationships*	*Other*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Cost				
At 1 January 2006	**1,318**	**119**	**3**	**1,440**
Additions	**936**	**866**	–	**1,802**
Disposals	**(32)**	–	–	**(32)**
Exchange and other movements	**17**	**37**	–	**54**
At 31 December 2006	**2,239**	**1,022**	**3**	**3,264**
Accumulated amortisation and impairment				
At 1 January 2006	**602**	**16**	**3**	**621**
Amortisation charge for the year	**281**	**41**	–	**322**
Disposals	**(31)**	–	–	**(31)**
Exchange and other movements	**12**	**1**	–	**13**
At 31 December 2006	**864**	**58**	**3**	**925**
Net book value at 31 December 2006	**1,375**	**964**	–	**2,339**

21 Goodwill and intangible assets *(continued)*

Bank

	Computer software	*Customer/ merchant relationships*	*Other*	*Total*
	HK$m	HK$m	HK$m	HK$m
Cost				
At 1 January 2005	701	119	3	823
Additions	636	–	–	636
Disposals	(15)	–	–	(15)
Exchange and other movements	(4)	–	–	(4)
At 31 December 2005	1,318	119	3	1,440
Accumulated amortisation and impairment				
At 1 January 2005	494	–	3	497
Amortisation charge for the year	124	16	–	140
Disposals	(13)	–	–	(13)
Exchange and other movements	(3)	–	–	(3)
At 31 December 2005	602	16	3	621
Net book value at 31 December 2005	716	103	–	819

There was no impairment on other intangible assets.

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 5 years to 12 years
Other	from 3 years to 5 years

22 Property, plant and equipment

a

	Group			Bank		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Cost or valuation at 1 January 2006	**21,943**	**4,473**	**12,161**	**12,509**	**125**	**8,389**
Exchange and other adjustments	**(459)**	**(355)**	**(100)**	**(188)**	**–**	**108**
Additions	**441**	**1**	**1,643**	**440**	**–**	**1,317**
Disposals	**(749)**	**(1,540)**	**(682)**	**(54)**	**–**	**(460)**
Elimination of accumulated depreciation on revalued premises	**(637)**	**–**	**–**	**(416)**	**–**	**–**
Surplus on revaluation	**2,047**	**319**	**–**	**1,202**	**–**	**–**
Reclassifications	**(49)**	**49**	**–**	**–**	**–**	**–**
At 31 December 2006	**22,537**	**2,947**	**13,022**	**13,493**	**125**	**9,354**

	Group			Bank		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Accumulated depreciation at 1 January 2006	**51**	**–**	**8,721**	**48**	**–**	**5,694**
Exchange and other adjustments	**3**	**–**	**–**	**4**	**–**	**71**
Charge for the year	**626**	**–**	**1,279**	**401**	**–**	**983**
Disposals	**(11)**	**–**	**(685)**	**(8)**	**–**	**(440)**
Elimination of accumulated depreciation on revalued premises	**(637)**	**–**	**–**	**(416)**	**–**	**–**
At 31 December 2006	**32**	**–**	**9,315**	**29**	**–**	**6,308**
Net book value at 31 December 2006	**22,505**	**2,947**	**3,707**	**13,464**	**125**	**3,046**
Total at 31 December 2006			**29,159**			**16,635**

Notes on the Financial Statements (continued)

22 Property, plant and equipment *(continued)*

	Group			Bank		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Cost or valuation at 1 January 2005	20,642	3,576	11,347	12,925	125	7,660
Exchange and other adjustments	(243)	–	(81)	(247)	–	(58)
Acquisition of subsidiaries	–	–	32	–	–	–
Additions	86	1	1,662	74	–	1,367
Disposals	(916)	(117)	(792)	(811)	–	(587)
Elimination of accumulated depreciation on revalued premises	(605)	–	–	(405)	–	–
Surplus on revaluation	2,818	1,167	–	980	–	–
Reclassifications	161	(154)	(7)	(7)	–	7
At 31 December 2005	21,943	4,473	12,161	12,509	125	8,389

	Group			Bank		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Accumulated depreciation at 1 January 2005	21	–	8,340	21	–	5,401
Exchange and other adjustments	3	–	(68)	(1)	–	(45)
Charge for the year	631	–	1,194	439	–	889
Acquisition of subsidiaries	–	–	32	–	–	–
Disposals	(7)	–	(769)	(6)	–	(551)
Elimination of accumulated depreciation on revalued premises	(605)	–	–	(405)	–	–
Reclassifications	8	–	(8)	–	–	–
At 31 December 2005	51	–	8,721	48	–	5,694
Net book value at 31 December 2005	21,892	4,473	3,440	12,461	125	2,695
Total at 31 December 2005			29,805			15,281

b The carrying amount of premises had it been stated at cost less accumulated depreciation would have been as follows:

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Cost less accumulated depreciation	**11,480**	10,740	**8,365**	8,174

22 Property, plant and equipment *(continued)*

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

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Premises carried at valuation	**22,344**	21,745	**13,307**	12,317
Other premises stated at cost	**193**	198	**186**	192
Premises before deduction of accumulated depreciation	**22,537**	21,943	**13,493**	12,509

d The net book value of premises and investment properties comprises:

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Long leaseholds (over fifty years)	**8,512**	10,642	**5,217**	5,307
Medium-term leaseholds (between ten and fifty years)	**13,650**	12,553	**5,301**	4,424
Short leaseholds (less than ten years)	**130**	134	**125**	129
	22,292	23,329	**10,643**	9,860
Outside Hong Kong:				
Freeholds	**2,236**	2,078	**2,102**	1,952
Long leaseholds (over fifty years)	**68**	61	**63**	55
Medium-term leaseholds (between ten and fifty years)	**679**	734	**607**	559
Short leaseholds (less than ten years)	**177**	163	**174**	160
	3,160	3,036	**2,946**	2,726
	25,452	26,365	**13,589**	12,586
Analysed as follows:				
Premises	**22,505**	21,892	**13,464**	12,461
Investment properties	**2,947**	4,473	**125**	125
	25,452	26,365	**13,589**	12,586

The group's premises and investment properties were revalued at 30 September 2006 and updated for any material changes at 31 December 2006. The basis of valuation for premises and investment properties was open market value or depreciated replacement cost as noted in note 3o. 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 'Premises' includes HK$6,274 million *(2005: HK$6,170 million)* in respect of properties which were valued using the depreciated replacement cost method.

The surplus on property revaluation was HK$2,366 million *(2005: HK$3,985 million)*. Amounts of HK$1,356 million *(2005: HK$1,662 million)* and HK$389 million *(2005: HK$1,537 million)* were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$1,356 million *(2005: HK$1,662 million)* is stated after deduction of minority interests of HK$238 million *(2005: HK$395 million)* and deferred tax of HK$383 million *(2005: HK$391 million)*. The amount credited to the income statement comprises the surplus of HK$319 million on revaluation of investment properties and HK$70 million relating to the reversal of previous revaluation deficits that had arisen when the value of certain premises fell below depreciable historical cost.

Premises and investment properties in the Hong Kong SAR, 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. 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.

22 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$196 million *(2005: HK$215 million)* 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*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**115**	184	**4**	4
After one but within five years	**53**	87	**3**	7
	168	271	**7**	11

23 Leasehold land and land use rights

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

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Leases over fifty years	**2,908**	2,931	**2,486**	2,502
Leases of between ten to fifty years	**1,106**	1,116	**125**	103
	4,014	4,047	**2,611**	2,605

The above amounts were included within 'Prepayments and accrued income' in 'Other assets'.

24 Other assets

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Current taxation recoverable	**604**	789	**580**	698
Assets held for sale	**4,976**	601	**4,609**	351
Prepayments and accrued income	**5,780**	5,038	**5,202**	4,678
Accrued interest receivable	**12,754**	10,476	**8,075**	6,592
Acceptances and endorsements	**26,729**	22,744	**23,443**	20,197
Other accounts	**9,074**	8,676	**4,743**	4,985
	59,917	48,324	**46,652**	37,501

Assets held for sale mainly comprises part of the Bank's New Zealand residential mortgage portfolio, the Bank's interest in an associate and assets acquired by repossession of collateral for realisation. The Bank has entered into a non-binding agreement to negotiate the sale of part of its New Zealand residential mortgage portfolio with a third party. The portfolio had a net book value of NZ$750 million as at 31 December 2006.

25 Deposits by banks

	Group 2006 HK$m	Group 2005 HK$m	Bank 2006 HK$m	Bank 2005 HK$m
Deposits by banks	**108,125**	83,802	**90,787**	75,674
Fair value	**108,127**	83,947	**90,788**	75,819

26 Customer accounts

	Group 2006 HK$m	Group 2005 HK$m	Bank 2006 HK$m	Bank 2005 HK$m
Current accounts	**292,450**	245,094	**219,377**	192,159
Savings accounts	**785,659**	682,412	**562,188**	493,254
Other deposit accounts	**911,358**	807,604	**641,954**	561,666
	1,989,467	1,735,110	**1,423,519**	1,247,079
Fair value	**1,989,509**	1,735,220	**1,423,462**	1,247,648

27 Trading liabilities

	Group 2006 HK$m	Group 2005 HK$m	Bank 2006 HK$m	Bank 2005 HK$m
Certificates of deposit in issue	**70,538**	83,937	**62,901**	75,008
Other debt securities in issue	**25,342**	20,361	**15,691**	11,791
Short positions in securities	**49,409**	55,025	**28,538**	34,340
Deposits by banks	**22,023**	13,488	**9,634**	5,063
Customer accounts	**105,233**	77,387	**66,106**	48,925
	272,545	250,198	**182,870**	175,127

28 Financial liabilities designated at fair value

	Group 2006 HK$m	Group 2005 HK$m	Bank 2006 HK$m	Bank 2005 HK$m
Deposits by banks	**356**	360	**356**	359
Customer accounts	**2,482**	1,600	**2,482**	1,600
Subordinated liabilities (note 34)	**987**	967	**–**	–
Liabilities to customers under investment contracts	**32,729**	30,364	**–**	–
	36,554	33,291	**2,838**	1,959

29 Debt securities in issue

	Group 2006 HK$m	Group 2005 HK$m	Bank 2006 HK$m	Bank 2005 HK$m
Certificates of deposit	**49,288**	49,068	**25,906**	20,139
Other debt securities	**19,907**	12,400	**8,588**	1,128
	69,195	61,468	**34,494**	21,267
Fair value	**69,065**	61,281	**34,503**	21,273

Notes on the Financial Statements (continued)

30 Other liabilities

	Group		Bank	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**16,073**	12,418	**12,031**	9,443
Provisions for liabilities and charges (note 33)	**984**	938	**880**	803
Dividend payable	**796**	796	**–**	–
Acceptances and endorsements	**26,729**	22,744	**23,443**	20,197
Other liabilities	**11,896**	9,732	**8,899**	7,247
	56,478	46,628	**45,253**	37,690

31 Liabilities under insurance contracts issued

	2006		
	Gross	**Reinsurance**	**Net**
	HK$m	**HK$m**	**HK$m**
Non-life insurance			
Unearned premiums	**804**	**(92)**	**712**
Outstanding claims	**1,191**	**(309)**	**882**
Claims incurred but not reported	**283**	**(51)**	**232**
Provision for unexpired risk	**7**	**–**	**7**
Other	**196**	**(1)**	**195**
Total non-life	**2,481**	**(453)**	**2,028**
Policyholders' liabilities			
Life (non-linked)	**49,643**	**(19)**	**49,624**
Investment contracts with discretionary participation features	**153**	**–**	**153**
Life (linked)	**9,073**	**(1)**	**9,072**
	58,869	**(20)**	**58,849**
Total liabilities under insurance contracts	**61,350**	**(473)**	**60,877**

31 Liabilities under insurance contracts issued *(continued)*

	2005		
	Gross HK$m	Reinsurance HK$m	Net HK$m
Non-life insurance			
Unearned premiums	713	(109)	604
Outstanding claims	1,189	(317)	872
Claims incurred but not reported	292	(60)	232
Provision for unexpired risk	15	–	15
Other	193	(77)	116
Total non-life	2,402	(563)	1,839
Policyholders' liabilities			
Life (non-linked)	32,646	(13)	32,633
Investment contracts with discretionary participation features	72	–	72
Life (linked)	6,725	(1)	6,724
	39,443	(14)	39,429
Total liabilities under insurance contracts	41,845	(577)	41,268

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

a *General economic and business assumptions*

The sensitivity of the group's profit and net assets arising from possible changes in assumptions used in respect of insurance businesses is set out below:

		Impact on 2006 results			Impact on 2005 results	
	2006 Movement	***Profit for the year***	***Net assets***	*2005 Movement*	*Profit for the year*	*Net assets*
Economic assumption		**HK$m**	**HK$m**		HK$m	HK$m
Exchange rate with USD	**-10%**	**68**	**68**	-10%	(38)	(38)
Claims cost inflation	**+20%**	**(53)**	**(53)**	+20%	(29)	(29)
Claims cost inflation	**-20%**	**53**	**53**	-20%	29	29
Non-economic assumption						
Mortality and/or morbidity	**+10%**	**(120)**	**(120)**	+10%	(97)	(97)
Mortality and/or morbidity	**-10%**	**120**	**120**	-10%	97	97
Lapse rate	**+50%**	**445**	**445**	+50%	287	287
Lapse rate	**-50%**	**(373)**	**(373)**	-50%	(247)	(247)
Expense rate	**+10%**	**(67)**	**(67)**	+10%	(75)	(75)
Expense rate	**-10%**	**67**	**67**	-10%	69	69

The assumptions used are based on estimates of future outcomes and historical experience. Annual reviews of the actual experience are performed.

Notes on the Financial Statements (continued)

31 Liabilities under insurance contracts issued *(continued)*

b *Movement of liabilities under insurance contracts*

(i) Non-life insurance

	2006		
	Gross HK$m	**Reinsurance HK$m**	**Net HK$m**
Unearned premiums			
At 1 January	**713**	**(109)**	**604**
Gross written premiums	**2,088**	**(364)**	**1,724**
Gross earned premiums	**(2,037)**	**384**	**(1,653)**
Foreign exchange and other movements	**40**	**(3)**	**37**
At 31 December	**804**	**(92)**	**712**
Notified and incurred but not reported claims			
At 1 January			
– Notified claims	**1,189**	**(317)**	**872**
– Claims incurred but not reported	**292**	**(60)**	**232**
	1,481	**(377)**	**1,104**
Claims paid in current year	**(788)**	**94**	**(694)**
Claims incurred	**747**	**(49)**	**698**
Foreign exchange and other movements	**34**	**(28)**	**6**
At 31 December			
– Notified claims	**1,191**	**(309)**	**882**
– Claims incurred but not reported	**283**	**(51)**	**232**
Total at 31 December	**1,474**	**(360)**	**1,114**

	2005		
	Gross HK$m	Reinsurance HK$m	Net HK$m
Unearned premiums			
At 1 January	647	(128)	519
Gross written premiums	2,009	(397)	1,612
Gross earned premiums	(1,955)	412	(1,543)
Foreign exchange and other movements	12	4	16
At 31 December	713	(109)	604
Notified and incurred but not reported claims			
At 1 January			
– Notified claims	1,206	(379)	827
– Claims incurred but not reported	389	(89)	300
	1,595	(468)	1,127
Claims paid in current year	(713)	96	(617)
Claims incurred	607	(10)	597
Foreign exchange and other movements	(8)	5	(3)
At 31 December			
– Notified claims	1,189	(317)	872
– Claims incurred but not reported	292	(60)	232
Total at 31 December	1,481	(377)	1,104

31 Liabilities under insurance contracts issued *(continued)*

(ii) Policyholders' liabilities

	2006		
	Gross HK$m	**Reinsurance HK$m**	**Net HK$m**
Life (non-linked)			
At 1 January	**32,646**	**(13)**	**32,633**
Benefits paid	**(825)**	**36**	**(789)**
Claims incurred	**17,565**	**(38)**	**17,527**
Foreign exchange and other movements	**257**	**(4)**	**253**
At 31 December	**49,643**	**(19)**	**49,624**
Investment contracts with discretionary participation features			
At 1 January	**72**	**–**	**72**
Benefits paid	**(1)**	**–**	**(1)**
Claims incurred	**47**	**–**	**47**
Foreign exchange and other movements	**35**	**–**	**35**
At 31 December	**153**	**–**	**153**
Life (linked)			
At 1 January	**6,725**	**(1)**	**6,724**
Benefits paid	**(2,143)**	**1**	**(2,142)**
Claims incurred	**4,209**	**(1)**	**4,208**
Foreign exchange and other movements	**282**	**–**	**282**
At 31 December	**9,073**	**(1)**	**9,072**
Total policyholders' liabilities	**58,869**	**(20)**	**58,849**

	2005		
	Gross HK$m	Reinsurance HK$m	Net HK$m
Life (non-linked)			
At 1 January	18,134	(13)	18,121
Benefits paid	(460)	32	(428)
Claims incurred	14,868	(31)	14,837
Foreign exchange and other movements	104	(1)	103
At 31 December	32,646	(13)	32,633
Investment contracts with discretionary participation features			
At 1 January	–	–	–
Claims incurred	70	–	70
Foreign exchange and other movements	2	–	2
At 31 December	72	–	72
Life (linked)			
At 1 January	5,971	–	5,971
Benefits paid	(1,071)	2	(1,069)
Claims incurred	1,812	(3)	1,809
Foreign exchange and other movements	13	–	13
At 31 December	6,725	(1)	6,724
Total policyholders' liabilities	39,443	(14)	39,429

Notes on the Financial Statements (continued)

32 Deferred tax

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

Group

	Accelerated capital allowances and short term timing differences	*Leasing transactions*	*Impairment losses on financial assets*	*Revaluation of properties*	*Others*	*Total*
2006	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January	**91**	**299**	**(587)**	**2,688**	**(34)**	**2,457**
Exchange and other adjustments	**36**	**(61)**	**(217)**	**21**	**115**	**(106)**
Charge/(credit) to income statement (note 5)	**(166)**	**(9)**	**(187)**	**(368)**	**680**	**(50)**
Charge to reserves	**–**	**–**	**–**	**208**	**530**	**738**
At 31 December	**(39)**	**229**	**(991)**	**2,549**	**1,291**	**3,039**
2005						
At 1 January	(105)	382	(802)	2,007	375	1,857
Exchange and other adjustments	(31)	(91)	234	25	193	330
Charge/(credit) to income statement (note 5)	227	8	(19)	225	38	479
Charge/(credit) to reserves	–	–	–	431	(640)	(209)
At 31 December	91	299	(587)	2,688	(34)	2,457

32 Deferred tax *(continued)*

Bank

2006	*Accelerated capital allowances and short term timing differences* HK$m	*Leasing transactions* HK$m	*Impairment losses on financial assets* HK$m	*Revaluation of properties* HK$m	*Others* HK$m	*Total* HK$m
At 1 January	**310**	**258**	**(437)**	**952**	**(627)**	**456**
Exchange and other adjustments	**22**	**(61)**	**(211)**	**61**	**151**	**(38)**
Charge/(credit) to income statement	**(177)**	**(13)**	**(192)**	**(84)**	**365**	**(101)**
Charge to reserves	**–**	**–**	**–**	**182**	**427**	**609**
At 31 December	**155**	**184**	**(840)**	**1,111**	**316**	**926**
2005						
At 1 January	(114)	304	(692)	810	(198)	110
Exchange and other adjustments	11	(43)	229	13	124	334
Charge/(credit) to income statement	413	(3)	26	13	(209)	240
Charge/(credit) to reserves	–	–	–	116	(344)	(228)
At 31 December	310	258	(437)	952	(627)	456

	Group		*Bank*	
	2006 **HK$m**	2005 HK$m	**2006** **HK$m**	2005 HK$m
Deferred tax liabilities recognised on the balance sheet	**4,284**	3,729	**1,679**	1,238
Deferred tax assets recognised on the balance sheet	**(1,245)**	(1,272)	**(753)**	(782)
	3,039	2,457	**926**	456

There is no significant deferred taxation liability not provided for.

At 31 December 2006, the group has not recognised potential future tax benefits of approximately HK$588 million *(2005: HK$697 million)* as it is not probable that future taxable profits against which the benefits can be utilised will be available in the relevant tax jurisdiction and entity. The losses do not expire under current tax legislation.

Notes on the Financial Statements (continued)

33 Provisions for liabilities and charges

Group

	Provisions for contingent liabilities and commitments	*Other provisions*	*Total*
	HK$m	**HK$m**	**HK$m**
2006			
At 1 January	**828**	**110**	**938**
Net charge to income statement	**45**	**77**	**122**
Provisions utilised	**(14)**	**(62)**	**(76)**
Exchange and other movements	**(4)**	**4**	**–**
At 31 December	**855**	**129**	**984**
2005			
At 1 January	634	133	767
Net charge to income statement	309	60	369
Provisions utilised	(15)	(84)	(99)
Exchange and other movements	(100)	1	(99)
At 31 December	828	110	938

Bank

	Provisions for contingent liabilities and commitments	*Other provisions*	*Total*
	HK$m	**HK$m**	**HK$m**
2006			
At 1 January	**705**	**98**	**803**
Net charge to income statement	**44**	**69**	**113**
Provisions utilised	**(14)**	**(49)**	**(63)**
Exchange and other movements	**23**	**4**	**27**
At 31 December	**758**	**122**	**880**
2005			
At 1 January	476	117	593
Net charge to income statement	329	47	376
Provisions utilised	(9)	(62)	(71)
Exchange and other movements	(91)	(4)	(95)
At 31 December	705	98	803

34 Subordinated liabilities

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

		2006 HK$m	2005 HK$m
US$1,200m	Primary capital subordinated undated floating rate notes*	**9,370**	9,359
Rs 2,000m	Fixed rate (13.05%) subordinated loans 2009	**351**	344
Bank		**9,721**	9,703
A$70m	Subordinated floating rate notes callable quarterly from 2006 to 2011	**–**	398
A$100m	Subordinated fixed rate (6.5%) until 2006 and floating thereafter, callable quarterly to 2011	**–**	568
A$70m	Subordinated floating rate notes callable quarterly from 2007 to 2012	**425**	397
A$200m	Subordinated floating rate notes callable quarterly from 2011 to 2016	**1,228**	–
HK$1,500m	Callable floating rate subordinated notes due 2015	**1,496**	1,495
US$450m	Callable floating rate subordinated notes due 2016	**3,483**	–
Group		**16,353**	12,561
Fair value			
– Bank		**9,148**	8,807
– Group		**15,718**	11,607

* *US$800 million of this subordinated capital is subject to an interest rate floor of 5%.*

The following subordinated note was classified as 'Financial liabilities designated at fair value' (note 28):

		Group	
		2006 HK$m	2005 HK$m
HK$1,000m	Callable fixed rate (4.125%) subordinated notes due 2015	**987**	967

35 Preference shares

Authorised

At 31 December 2006, the authorised preference share capital of the Bank was US$10,250,500,000 *(2005: US$ 9,700,500,000)* comprising 550,500,000 cumulative redeemable preference shares of US$1 each, 7,500 million non-cumulative irredeemable preference shares of US$1 each and 2,200 million cumulative irredeemable preference shares of US$1 each *(2005: comprising 500,000 cumulative redeemable preference shares of US$1 each, 7,500 million non-cumulative irredeemable preference shares of US$1 each and 2,200 million cumulative irredeemable preference shares of US$1 each).*

Notes on the Financial Statements (continued)

35 Preference shares *(continued)*

Issued and fully paid

	Bank and Group	
	2006	2005
	HK$m	HK$m
Redeemable preference shares	**4,281**	4
Irredeemable preference shares	**68,299**	68,103
Share premium	**3,884**	3,873
	76,464	71,980
Fair value	**77,163**	72,769

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 during the year (*2005: nil*), 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. The total number of issued cumulative redeemable preference shares at 31 December 2006 was 550,500,000 *(2005: 500,000)*.

The non-cumulative irredeemable preference shares are 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 2006 was 6,653 million *(2005: 6,653 million)*. No shares were issued during the year *(2005: nil)*.

The cumulative irredeemable preference shares are 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 2006 was 2,130 million *(2005: 2,130 million)*. No shares were issued during the year *(2005: 2,130 million)*.

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

36 Share Capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2006 and 2005 was HK$30,000 million divided into 12,000 million ordinary shares of HK$2.50 each. No new shares were issued during 2006.

Issued and fully paid

	Bank and Group	
	2006	2005
	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 the meetings of the Bank.

37 Reserves

Group

	2006								
		Other reserves							
	Retained profits	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total share-holders' equity*	*Minority interests*	*Total equity*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January 2006	**64,303**	**4,082**	**2,899**	**(1,767)**	**53**	**770**	**70,340**	**17,091**	**87,431**
Unrealised surplus on revaluation	**–**	**1,739**	**–**	**–**	**–**	**–**	**1,739**	**238**	**1,977**
Transfer of depreciation	**218**	**(218)**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Realisation on disposal of properties	**656**	**(656)**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Profit for the year attributable to shareholders	**37,709**	**–**	**–**	**–**	**–**	**–**	**37,709**	**–**	**37,709**
Profit for the year attributable to minority interests	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**4,896**	**4,896**
Dividends	**(20,757)**	**–**	**–**	**–**	**–**	**–**	**(20,757)**	**(3,841)**	**(24,598)**
Employees' options granted by ultimate holding company	**–**	**–**	**–**	**–**	**–**	**453**	**453**	**32**	**485**
Actuarial (losses)/gains on defined benefit plans	**(8)**	**–**	**–**	**–**	**–**	**–**	**(8)**	**101**	**93**
Fair value gains/(losses) taken to equity	**–**	**–**	**24,612**	**(119)**	**–**	**–**	**24,493**	**457**	**24,950**
Amounts transferred to the income statement	**–**	**–**	**(1,344)**	**2,111**	**–**	**–**	**767**	**46**	**813**
Transfer to income statement on change in fair value of hedged items	**–**	**–**	**(113)**	**–**	**–**	**–**	**(113)**	**8**	**(105)**
Share of changes recognised directly in equity of associates	**65**	**40**	**(286)**	**–**	**(5)**	**–**	**(186)**	**–**	**(186)**
Exchange differences	**1,055**	**–**	**39**	**(15)**	**1,614**	**17**	**2,710**	**69**	**2,779**
Deferred tax	**(126)**	**(189)**	**(19)**	**(329)**	**–**	**–**	**(663)**	**(75)**	**(738)**
Transfers	**(2,122)**	**–**	**7**	**(47)**	**1,143**	**1,019**	**–**	**–**	**–**
Other movements	**(51)**	**–**	**17**	**–**	**–**	**6**	**(28)**	**–**	**(28)**
Other increase in minority interest stake	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**973**	**973**
At 31 December 2006	**80,942**	**4,798**	**25,812**	**(166)**	**2,805**	**2,265**	**116,456**	**19,995**	**136,451**

Notes on the Financial Statements (continued)

37 Reserves *(continued)*

Bank

	2006						
		Other reserves					
	Retained profits	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total equity*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January 2006	**29,996**	**72**	**1,344**	**(1,528)**	**436**	**462**	**30,782**
Unrealised surplus on revaluation	**–**	**1,154**	**–**	**–**	**–**	**–**	**1,154**
Transfer of depreciation	**113**	**(113)**	**–**	**–**	**–**	**–**	**–**
Realisation on disposal of properties	**230**	**(230)**	**–**	**–**	**–**	**–**	**–**
Profit for the year attributable to shareholders	**32,532**	**–**	**–**	**–**	**–**	**–**	**32,532**
Dividends	**(20,757)**	**–**	**–**	**–**	**–**	**–**	**(20,757)**
Employees' options granted by ultimate holding company	**–**	**–**	**–**	**–**	**–**	**346**	**346**
Actuarial losses on defined benefit plans	**(173)**	**–**	**–**	**–**	**–**	**–**	**(173)**
Fair value gains/(losses) taken to equity	**–**	**–**	**22,826**	**(43)**	**–**	**–**	**22,783**
Amounts transferred to the income statement	**–**	**–**	**(284)**	**1,836**	**–**	**–**	**1,552**
Transfer to income statement on change in fair value of hedged items	**–**	**–**	**(135)**	**–**	**–**	**–**	**(135)**
Exchange differences	**3**	**–**	**14**	**(13)**	**1,293**	**5**	**1,302**
Deferred tax	**(75)**	**(182)**	**(56)**	**(296)**	**–**	**–**	**(609)**
Transfers	**(8)**	**–**	**(11)**	**14**	**10**	**(5)**	**–**
Other movements	**5**	**–**	**9**	**(2)**	**–**	**–**	**12**
At 31 December 2006	**41,866**	**701**	**23,707**	**(32)**	**1,739**	**808**	**68,789**

37 Reserves *(continued)*

Group

	2005								
		Other reserves							
	Retained profits	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total share-holders' equity*	*Minority interests*	*Total equity*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 1 January 2005	50,445	3,065	3,257	(125)	843	322	57,807	16,658	74,465
Unrealised surplus on revaluation	–	2,053	–	–	–	–	2,053	395	2,448
Transfer of depreciation	173	(173)	–	–	–	–	–	–	–
Realisation on disposal of properties	523	(523)	–	–	–	–	–	–	–
Profit for the year attributable to shareholders	32,873	–	–	–	–	–	32,873	–	32,873
Profit for the year attributable to minority interests	–	–	–	–	–	–	–	4,325	4,325
Dividends	(20,300)	–	–	–	–	–	(20,300)	(3,983)	(24,283)
Employees' options granted by ultimate holding company	–	–	–	–	–	307	307	26	333
Actuarial gains on defined benefit plans	73	–	–	–	–	–	73	71	144
Fair value losses taken to equity	–	–	(1,317)	(2,522)	–	–	(3,839)	(789)	(4,628)
Amounts transferred to the income statement	–	–	(587)	538	–	–	(49)	(200)	(249)
Transfer to income statement on change in fair value of hedged items	–	–	983	–	–	–	983	94	1,077
Share of changes recognised directly in equity of associates	541	–	557	–	–	–	1,098	–	1,098
Exchange differences	7	(65)	(101)	1	(637)	(2)	(797)	15	(782)
Deferred tax	(31)	(307)	195	342	–	–	199	54	253
Transfers	(18)	65	101	–	(153)	5	–	–	–
Other movements	17	(33)	(189)	(1)	–	138	(68)	–	(68)
Other increase in minority interest stake	–	–	–	–	–	–	–	425	425
At 31 December 2005	64,303	4,082	2,899	(1,767)	53	770	70,340	17,091	87,431

37 Reserves *(continued)*

Bank

	2005						
		Other reserves					
	Retained profits	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total equity*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 1 January 2005	22,183	–	1,710	(117)	819	244	24,839
Unrealised surplus on revaluation	–	779	–	–	–	–	779
Transfer of depreciation	92	(92)	–	–	–	–	–
Realisation on disposal of properties	463	(463)	–	–	–	–	–
Profit for the year attributable to shareholders	27,578	–	–	–	–	–	27,578
Dividends	(20,300)	–	–	–	–	–	(20,300)
Employees' options granted by ultimate holding company	–	–	–	–	–	232	232
Actuarial losses on defined benefit plans	(17)	–	–	–	–	–	(17)
Fair value losses taken to equity	–	–	(907)	(2,232)	–	–	(3,139)
Amounts transferred to the income statement	–	–	(300)	534	–	–	234
Transfer to income statement on change in fair value of hedged items	–	–	806	–	–	–	806
Exchange differences	327	(65)	(13)	2	(634)	–	(383)
Deferred tax	(4)	(116)	102	288	–	–	270
Transfers	(327)	65	13	(2)	251	–	–
Other movements	1	(36)	(67)	(1)	–	(14)	(117)
At 31 December 2005	29,996	72	1,344	(1,528)	436	462	30,782

37 Reserves *(continued)*

The Bank and its banking subsidiary companies operate under regulatory jurisdictions which require the maintenance of minimum impairment provisions in excess of those required under Hong Kong Accounting Standards. At 31 December 2006, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$1,689 million (*2005: HK$1,319 million*).

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 original 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 corresponding amount relating to share options granted to employees of the group directly by HSBC Holdings plc.

Minority interests

Minority interests represent the portion of equity interests that are not owned, directly or indirectly through subsidiaries, by the Bank.

The property revaluation, available-for-sale investment, cash flow hedge and other reserves do not represent realised profits and are not available for distribution.

38 Maturity analysis of assets and liabilities

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

Group

2006	*On demand*	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
ASSETS									
Cash and short-term funds	**160,649**	**294,994**	**57,965**	**4,414**	**–**	**–**	**–**	**–**	**518,022**
Items in the course of collection from other banks	**–**	**46,519**	**–**	**–**	**–**	**–**	**–**	**–**	**46,519**
Placings with banks maturing after one month	**–**	**77,642**	**21,690**	**2,170**	**2,535**	**–**	**–**	**–**	**104,037**
Certificates of deposit	**–**	**22,022**	**21,990**	**26,974**	**2,214**	**–**	**–**	**–**	**73,200**
Hong Kong SAR Government certificates of indebtedness	**102,374**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**102,374**
Trading assets	**–**	**–**	**–**	**–**	**–**	**–**	**338,792**	**–**	**338,792**
Financial assets designated at fair value	**–**	**1,396**	**10,458**	**7,840**	**3,608**	**27,212**	**–**	**–**	**50,514**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**94,747**	**4,420**	**99,167**
Advances to customers	**86,988**	**213,389**	**156,306**	**300,390**	**293,552**	**(6,843)**	**–**	**–**	**1,043,782**
Financial investments	**–**	**68,186**	**108,520**	**220,879**	**47,967**	**39,289**	**–**	**–**	**484,841**
Amounts due from group companies	**–**	**124,448**	**3,242**	**–**	**–**	**–**	**33,428**	**–**	**161,118**
Investments in associates and joint venture	**–**	**–**	**–**	**–**	**–**	**25,534**	**–**	**–**	**25,534**
Goodwill and intangible assets	**–**	**–**	**–**	**–**	**–**	**10,428**	**–**	**–**	**10,428**
Property, plant and equipment	**–**	**–**	**–**	**–**	**–**	**29,159**	**–**	**–**	**29,159**
Deferred tax assets	**–**	**–**	**–**	**–**	**–**	**1,245**	**–**	**–**	**1,245**
Retirement benefits	**–**	**–**	**–**	**–**	**–**	**2,191**	**–**	**–**	**2,191**
Other assets	**4,018**	**37,652**	**9,968**	**1,230**	**185**	**6,864**	**–**	**–**	**59,917**
Total assets at 31 December 2006	**354,029**	**886,248**	**390,139**	**563,897**	**350,061**	**135,079**	**466,967**	**4,420**	**3,150,840**

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

Group

	On demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
LIABILITIES									
Hong Kong SAR currency notes in circulation	**102,374**	–	–	–	–	–	–	–	**102,374**
Items in the course of transmission to other banks	–	**57,226**	–	–	–	–	–	–	**57,226**
Deposits by banks	**43,196**	**53,468**	**11,340**	**36**	**85**	–	–	–	**108,125**
Customer accounts	**1,258,318**	**645,707**	**74,290**	**8,522**	**2,630**	–	–	–	**1,989,467**
Trading liabilities	–	–	–	–	–	–	**272,545**	–	**272,545**
Financial liabilities designated at fair value	**611**	**813**	**146**	**1,831**	**1,391**	**31,762**	–	–	**36,554**
Derivatives	–	–	–	–	–	–	**97,848**	**811**	**98,659**
Debt securities in issue	–	**30,632**	**22,225**	**16,260**	**78**	–	–	–	**69,195**
Retirement benefit liabilities	–	–	–	–	–	**465**	–	–	**465**
Amounts due to group companies	–	**15,320**	**2,933**	**11**	**2,125**	–	**10,967**	–	**31,356**
Other liabilities	**3,560**	**34,304**	**4,299**	**532**	–	**13,783**	–	–	**56,478**
Liabilities under insurance contracts issued	–	–	–	–	–	**61,350**	–	–	**61,350**
Current tax liabilities	**70**	**1,459**	**2,944**	–	**27**	–	–	–	**4,500**
Deferred tax liabilities	–	–	–	–	–	**4,284**	–	–	**4,284**
Subordinated liabilities	–	–	**423**	**6,554**	–	**9,376**	–	–	**16,353**
Preference shares	–	–	–	–	**8,165**	**68,299**	–	–	**76,464**
Total liabilities at 31 December 2006	**1,408,129**	**838,929**	**118,600**	**33,746**	**14,501**	**189,319**	**381,360**	**811**	**2,985,395**

Notes on the Financial Statements (continued)

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

Bank

2006	*On demand*	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
ASSETS									
Cash and short-term funds	**130,699**	**233,098**	**57,965**	**4,414**	**–**	**–**	**–**	**–**	**426,176**
Items in the course of collection from other banks	**–**	**40,434**	**–**	**–**	**–**	**–**	**–**	**–**	**40,434**
Placings with banks maturing after one month	**–**	**54,200**	**20,344**	**2,170**	**2,535**	**–**	**–**	**–**	**79,249**
Certificates of deposit	**–**	**12,177**	**16,318**	**4,686**	**726**	**–**	**–**	**–**	**33,907**
Hong Kong SAR Government certificates of indebtedness	**102,374**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**102,374**
Trading assets	**–**	**–**	**–**	**–**	**–**	**–**	**284,057**	**–**	**284,057**
Financial assets designated at fair value	**–**	**184**	**7,347**	**2,219**	**1,391**	**41**	**–**	**–**	**11,182**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**94,262**	**3,572**	**97,834**
Advances to customers	**59,113**	**166,495**	**102,854**	**186,190**	**177,518**	**(5,702)**	**–**	**–**	**686,468**
Financial investments	**–**	**49,593**	**60,165**	**83,746**	**15,230**	**34,489**	**–**	**–**	**243,223**
Amounts due from group companies	**–**	**115,992**	**3,798**	**1,159**	**10,227**	**–**	**37,941**	**–**	**169,117**
Investments in subsidiary companies	**–**	**–**	**–**	**–**	**–**	**7,828**	**–**	**–**	**7,828**
Investments in associates and joint venture	**–**	**–**	**–**	**–**	**–**	**17,508**	**–**	**–**	**17,508**
Goodwill and intangible assets	**–**	**–**	**–**	**–**	**–**	**3,360**	**–**	**–**	**3,360**
Property, plant and equipment	**–**	**–**	**–**	**–**	**–**	**16,635**	**–**	**–**	**16,635**
Deferred tax assets	**–**	**–**	**–**	**–**	**–**	**753**	**–**	**–**	**753**
Retirement benefits	**–**	**–**	**–**	**–**	**–**	**1,273**	**–**	**–**	**1,273**
Other assets	**3,026**	**29,721**	**8,675**	**1,084**	**158**	**3,988**	**–**	**–**	**46,652**
Total assets at 31 December 2006	**295,212**	**701,894**	**277,466**	**285,668**	**207,785**	**80,173**	**416,260**	**3,572**	**2,268,030**

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

Bank

	On demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
LIABILITIES									
Hong Kong SAR currency notes in circulation	**102,374**	–	–	–	–	–	–	–	**102,374**
Items in the course of transmission to other banks	–	**50,618**	–	–	–	–	–	–	**50,618**
Deposits by banks	**37,574**	**42,873**	**10,219**	**36**	**85**	–	–	–	**90,787**
Customer accounts	**917,075**	**439,001**	**57,808**	**6,960**	**2,675**	–	–	–	**1,423,519**
Trading liabilities	–	–	–	–	–	–	**182,870**	–	**182,870**
Financial liabilities designated at fair value	–	**812**	**146**	**489**	**1,391**	–	–	–	**2,838**
Derivatives	–	–	–	–	–	–	**98,598**	**572**	**99,170**
Debt securities in issue	–	**18,857**	**11,327**	**4,294**	**16**	–	–	–	**34,494**
Retirement benefit liabilities	–	–	–	–	–	**447**	–	–	**447**
Amounts due to group companies	–	**12,199**	**3,955**	**1,285**	**9,187**	–	**20,975**	–	**47,601**
Other liabilities	**3,334**	**27,144**	**4,015**	**459**	–	**10,301**	–	–	**45,253**
Current tax liabilities	**66**	**953**	**1,366**	–	**27**	–	–	–	**2,412**
Deferred tax liabilities	–	–	–	–	–	**1,679**	–	–	**1,679**
Subordinated liabilities	–	–	–	**351**	–	**9,370**	–	–	**9,721**
Preference shares	–	–	–	–	**8,165**	**68,299**	–	–	**76,464**
Total liabilities at 31 December 2006	**1,060,423**	**592,457**	**88,836**	**13,874**	**21,546**	**90,096**	**302,443**	**572**	**2,170,247**

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

Group

2005	*On demand*	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
ASSETS									
Cash and short-term funds	178,227	276,086	47,771	646	–	–	–	–	502,730
Items in the course of collection from other banks	–	17,782	–	–	–	–	–	–	17,782
Placings with banks maturing after one month	–	26,298	37,692	2,606	2,958	–	–	–	69,554
Certificates of deposit	–	18,092	15,673	17,752	2,314	–	–	–	53,831
Hong Kong SAR Government certificates of indebtedness	97,344	–	–	–	–	–	–	–	97,344
Trading assets	–	–	–	–	–	–	215,681	–	215,681
Financial assets designated at fair value	–	2,723	4,268	9,073	2,355	18,654	–	–	37,073
Derivatives	–	–	–	–	–	–	69,724	2,315	72,039
Advances to customers	73,530	195,141	146,344	307,047	283,840	(6,576)	–	–	999,326
Financial investments	–	42,238	72,084	214,649	50,128	15,398	–	–	394,497
Amounts due from group companies	–	75,552	6,231	57	–	–	19,333	–	101,173
Investments in associates and joint venture	–	–	–	–	–	23,061	–	–	23,061
Goodwill and intangible assets	–	–	–	–	–	7,252	–	–	7,252
Property, plant and equipment	–	–	–	–	–	29,805	–	–	29,805
Deferred tax assets	–	–	–	–	–	1,272	–	–	1,272
Retirement benefits	–	–	–	–	–	1,788	–	–	1,788
Other assets	4,100	30,858	6,345	828	5	6,188	–	–	48,324
Total assets at 31 December 2005	353,201	684,770	336,408	552,658	341,600	96,842	304,738	2,315	2,672,532

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

Group

	On demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
LIABILITIES									
Hong Kong SAR currency notes in circulation	97,344	–	–	–	–	–	–	–	97,344
Items in the course of transmission to other banks	–	20,927	–	–	–	–	–	–	20,927
Deposits by banks	36,649	39,139	6,339	1,590	85	–	–	–	83,802
Customer accounts	1,026,453	635,437	58,656	11,970	2,594	–	–	–	1,735,110
Trading liabilities	–	–	–	–	–	–	250,198	–	250,198
Financial liabilities designated at fair value	–	–	–	438	2,839	30,014	–	–	33,291
Derivatives	–	–	–	–	–	–	70,933	1,076	72,009
Debt securities in issue	–	23,038	18,666	19,712	50	2	–	–	61,468
Retirement benefit liabilities	–	–	–	–	–	394	–	–	394
Amounts due to group companies	–	16,844	3,109	1,392	2,106	–	1,326	–	24,777
Other liabilities	2,657	27,206	4,931	510	–	11,324	–	–	46,628
Liabilities under insurance contracts issued	–	–	–	–	–	41,845	–	–	41,845
Current tax liabilities	371	723	950	–	–	–	–	–	2,044
Deferred tax liabilities	–	–	–	–	–	3,729	–	–	3,729
Subordinated liabilities	–	–	–	344	2,858	9,359	–	–	12,561
Preference shares	–	–	–	–	3,877	68,103	–	–	71,980
Total liabilities at 31 December 2005	1,163,474	763,314	92,651	35,956	14,409	164,770	322,457	1,076	2,558,107

Notes on the Financial Statements (continued)

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

Bank

2005	*On demand*	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
ASSETS									
Cash and short-term funds	151,225	230,487	47,771	646	–	–	–	–	430,129
Items in the course of collection from other banks	–	9,705	–	–	–	–	–	–	9,705
Placings with banks maturing after one month	–	15,170	32,671	2,406	2,958	–	–	–	53,205
Certificates of deposit	–	13,507	5,864	2,923	707	–	–	–	23,001
Hong Kong SAR Government certificates of indebtedness	97,344	–	–	–	–	–	–	–	97,344
Trading assets	–	–	–	–	–	–	173,169	–	173,169
Financial assets designated at fair value	–	1,883	2,685	3,004	1,102	81	–	–	8,755
Derivatives	–	–	–	–	–	–	68,572	1,756	70,328
Advances to customers	48,891	157,731	103,125	190,759	169,487	(5,348)	–	–	664,645
Financial investments	–	34,201	41,138	83,015	26,288	12,042	–	–	196,684
Amounts due from group companies	–	79,082	8,789	1,223	9,732	–	21,151	–	119,977
Investments in subsidiary companies	–	–	–	–	–	6,248	–	–	6,248
Investments in associates and joint venture	–	–	–	–	–	17,242	–	–	17,242
Goodwill and intangible assets	–	–	–	–	–	1,571	–	–	1,571
Property, plant and equipment	–	–	–	–	–	15,281	–	–	15,281
Deferred tax assets	–	–	–	–	–	782	–	–	782
Retirement benefits	–	–	–	–	–	1,252	–	–	1,252
Other assets	3,277	24,716	5,541	781	–	3,186	–	–	37,501
Total assets at 31 December 2005	300,737	566,482	247,584	284,757	210,274	52,337	262,892	1,756	1,926,819

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

Bank

	On demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
LIABILITIES									
Hong Kong SAR currency notes in circulation	97,344	–	–	–	–	–	–	–	97,344
Items in the course of transmission to other banks	–	14,317	–	–	–	–	–	–	14,317
Deposits by banks	34,965	32,703	6,331	1,590	85	–	–	–	75,674
Customer accounts	763,441	423,606	46,830	10,558	2,644	–	–	–	1,247,079
Trading liabilities	–	–	–	–	–	–	175,127	–	175,127
Financial liabilities designated at fair value	–	–	–	115	1,844	–	–	–	1,959
Derivatives	–	–	–	–	–	–	70,812	598	71,410
Debt securities in issue	–	12,839	7,380	1,048	–	–	–	–	21,267
Retirement benefit liabilities	–	–	–	–	–	379	–	–	379
Amounts due to group companies	–	15,654	3,325	4,008	7,944	–	11,488	–	42,419
Other liabilities	2,500	21,612	4,691	472	–	8,415	–	–	37,690
Current tax liabilities	–	714	743	–	–	–	–	–	1,457
Deferred tax liabilities	–	–	–	–	–	1,238	–	–	1,238
Subordinated liabilities	–	–	–	344	–	9,359	–	–	9,703
Preference shares	–	–	–	–	3,877	68,103	–	–	71,980
Total liabilities at 31 December 2005	898,250	521,445	69,300	18,135	16,394	87,494	257,427	598	1,869,043

Notes on the Financial Statements (continued)

39 Analysis of cash flows payable under financial liabilities by remaining contractual maturities at balance sheet date

Group

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2006						
Deposits by banks	**43,238**	**53,799**	**11,636**	**37**	**87**	**108,797**
Customer accounts	**1,259,156**	**649,612**	**76,560**	**9,750**	**2,667**	**1,997,745**
Financial liabilities designated at fair value	**611**	**832**	**201**	**2,008**	**33,209**	**36,861**
Debt securities in issue	**–**	**31,307**	**23,115**	**17,871**	**87**	**72,380**
Amounts due to group companies	**–**	**15,348**	**3,025**	**493**	**2,649**	**21,515**
Other financial liabilities	**3,485**	**28,535**	**5,359**	**2,312**	**11,530**	**51,221**
Subordinated liabilities	**–**	**270**	**1,097**	**9,911**	**14,580**	**25,858**
Preference shares	**–**	**1,298**	**3,837**	**20,538**	**126,166**	**151,839**
	1,306,490	**781,001**	**124,830**	**62,920**	**190,975**	**2,466,216**

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 31 December 2005						
Deposits by banks	36,658	39,285	6,431	1,755	87	84,216
Customer accounts	1,026,571	638,188	59,861	12,755	2,676	1,740,051
Financial liabilities designated at fair value	182	19	57	1,762	31,813	33,833
Debt securities in issue	1	23,719	19,711	21,253	80	64,764
Amounts due to group companies	–	16,868	3,187	1,798	2,645	24,498
Other financial liabilities	2,339	23,199	6,968	3,144	9,588	45,238
Subordinated liabilities	–	179	1,432	4,481	13,763	19,855
Preference shares	–	974	2,959	15,734	111,155	130,822
	1,065,751	742,431	100,606	62,682	171,807	2,143,277

39 Analysis of cash flows payable under financial liabilities by remaining contractual maturities at balance sheet date *(continued)*

Bank

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2006						
Deposits by banks	**37,614**	**43,164**	**10,481**	**37**	**87**	**91,383**
Customer accounts	**917,303**	**441,612**	**59,620**	**7,978**	**2,699**	**1,429,212**
Financial liabilities designated at fair value	**–**	**818**	**164**	**558**	**1,438**	**2,978**
Debt securities in issue	**–**	**19,065**	**11,511**	**4,853**	**18**	**35,447**
Amounts due to group companies	**–**	**12,227**	**4,047**	**1,767**	**9,711**	**27,752**
Other financial liabilities	**3,258**	**22,785**	**4,033**	**928**	**8,355**	**39,359**
Subordinated liabilities	**–**	**176**	**395**	**2,543**	**14,580**	**17,694**
Preference shares	**–**	**1,298**	**3,837**	**20,538**	**126,166**	**151,839**
	958,175	**541,145**	**94,088**	**39,202**	**163,054**	**1,795,664**

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 31 December 2005						
Deposits by banks	34,965	32,837	6,423	1,755	86	76,066
Customer accounts	763,442	425,239	47,757	11,199	2,717	1,250,354
Financial liabilities designated at fair value	–	9	26	252	1,954	2,241
Debt securities in issue	1	13,016	7,525	1,196	29	21,767
Amounts due to group companies	–	15,678	3,403	4,414	8,483	31,978
Other financial liabilities	2,146	19,914	5,130	865	6,771	34,826
Subordinated liabilities	–	150	341	2,263	13,763	16,517
Preference shares	–	974	2,959	15,734	111,155	130,822
	800,554	507,817	73,564	37,678	144,958	1,564,571

Notes on the Financial Statements (continued)

39 Analysis of cash flows payable under financial liabilities by remaining contractual maturities at balance sheet date *(continued)*

The above tables show the undiscounted cash flows on the group's financial liabilities including future interest payments on the basis of their earliest possible contractual maturity. The group's expected cash flows on these instruments vary significantly from this analysis. For example, demand deposits from customers are expected to maintain a stable or increasing balance although they have been classified as on demand in the above tables.

Liabilities in trading portfolios have not been analysed by contractual maturity because trading assets and liabilities are typically held for short periods of time. Assets available to meet these liabilities, and to cover outstanding commitments to lend (HK$1,040 billion), include cash and short-term funds and items in the course of collection (HK$565 billion); placings with banks maturing after one month (HK$104 billion including HK$99 billion repayable within one year); and advances to customers (HK$1,044 billion, including HK$457 billion repayable within one year). In the normal course of business, a proportion of customer loans which are contractually repayable within one year will be extended.

The group would meet unexpected net cash outflows by selling securities and accessing additional funding sources such as interbank or asset-backed markets.

40 Reconciliation of operating profit to cash generated from operations

	2006	2005
	HK$m	HK$m
Operating profit	**49,277**	43,344
Net interest income	**(51,099)**	(43,491)
Dividend income	**(749)**	(368)
Depreciation and amortisation	**2,248**	1,983
Amortisation of prepaid operating lease payments	**58**	56
Loan impairment charges and other credit risk provisions	**4,809**	2,064
Advances written off net of recoveries	**(4,316)**	(3,268)
Other provisions for liabilities and charges	**93**	373
Provisions utilised	**(76)**	(99)
Surplus arising on property revaluation	**(70)**	(370)
Gains on investment properties	**(475)**	(1,167)
Profit on disposal of property, plant and equipment and assets held for sale	**(981)**	(111)
Profit on disposal of subsidiaries, associates and business portfolios	**(904)**	(53)
Gains less losses from financial investments	**(1,466)**	(756)
Employees' options granted cost free	**485**	333
Interest received	**95,646**	63,331
Interest paid	**(57,763)**	(31,956)
Operating profit before changes in working capital	**34,717**	29,845
Change in treasury bills with original term to maturity of more than three months	**(5,063)**	10,704
Change in placings with banks maturing after one month	**(34,537)**	4,139
Change in certificates of deposit with original term to maturity of more than three months	**(15,388)**	(2,351)
Change in trading assets	**(63,574)**	(85,741)
Change in trading liabilities	**22,347**	87,174
Change in financial assets designated as fair value	**(13,539)**	(1,001)
Change in financial liabilities designated as fair value	**3,263**	2,521
Change in derivatives assets	**(27,128)**	15,122
Change in derivatives liabilities	**26,651**	(21,007)
Change in financial investments held for backing liabilities to long-term policyholders	**(11,742)**	(8,227)
Change in advances to customers	**(60,172)**	(82,836)
Change in amounts due from group companies	**(60,055)**	(20,058)
Change in other assets	**(26,387)**	13,509
Change in deposits by banks	**24,323**	11,147
Change in customer accounts	**254,357**	41,993
Change in amounts due to group companies	**6,247**	8,387
Change in debt securities in issue	**7,727**	(2,221)
Change in liabilities under insurance contracts	**19,505**	15,423
Change in other liabilities	**5,202**	15,750
Exchange adjustments	**2,188**	(1,263)
Cash generated from operations	**88,942**	31,009

Notes on the Financial Statements (continued)

41 Analysis of cash and cash equivalents

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

	2006 HK$m	2005 HK$m
Balance at 1 January	**444,514**	403,545
Net cash inflow before the effect of foreign exchange movements	**59,139**	56,138
Effect of foreign exchange movements	**6,956**	(15,169)
Balance at 31 December	**510,609**	444,514

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

	2006 HK$m	2005 HK$m
Cash in hand and current balances with banks	**48,033**	86,882
Items in the course of collection from other banks	**46,519**	17,782
Placings with banks	**372,015**	310,396
Treasury bills	**88,895**	45,484
Certificates of deposit	**12,373**	4,897
Less: items in the course of transmission to other banks	**(57,226)**	(20,927)
	510,609	444,514

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

	2006 HK$m	2005 HK$m
Cash consideration	**(22)**	(2,391)
Cash and cash equivalents acquired	**–**	747
	(22)	(1,644)

d *Analysis of net inflow of cash and cash equivalents in respect of the sale of subsidiary companies*

	2006 HK$m	2005 HK$m
Sale proceeds	**441**	151
Cash and cash equivalents transferred	**(32)**	–
	409	151

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

	2006 HK$m	2005 HK$m
Sale proceeds	**16,501**	–
Cash and cash equivalents transferred	**–**	–
	16,501	–

f *Analysis of net outflow of cash and cash equivalents in respect of the purchase of interests in business portfolios*

	2006 HK$m	2005 HK$m
Cash consideration	**(775)**	–
Cash and cash equivalents acquired	**–**	–
	(775)	–

42 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

Group

	2006			2005		
	Contract amount	*Credit equivalent amount*	*Risk-weighted amount*	*Contract amount*	*Credit equivalent amount*	*Risk-weighted amount*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Contingent liabilities:						
Guarantees	**100,964**	**73,862**	**60,534**	83,114	60,166	48,893
Other contingent liabilities	**35**	**35**	**35**	37	37	37
	100,999	**73,897**	**60,569**	83,151	60,203	48,930
Commitments:						
Documentary credits and short-term trade-related transactions	**56,732**	**21,632**	**11,680**	55,402	20,650	10,905
Undrawn note issuing and revolving underwriting facilities	**1,166**	**583**	**–**	3,249	1,625	975
Undrawn formal standby facilities, credit lines and other commitments:						
– one year and over	**94,241**	**47,120**	**43,635**	97,207	48,604	41,115
– under one year	**887,680**	**–**	**–**	752,797	–	–
	1,039,819	**69,335**	**55,315**	908,655	70,879	52,995

42 Contingent liabilities and commitments *(continued)*

Bank

	2006			2005		
	Contract amount	*Credit equivalent amount*	*Risk-weighted amount*	*Contract amount*	*Credit equivalent amount*	*Risk-weighted amount*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Contingent liabilities:						
Guarantees	**93,074**	**67,325**	**51,991**	85,796	64,041	42,583
Other contingent liabilities	**34**	**34**	**34**	32	32	32
	93,108	**67,359**	**52,025**	85,828	64,073	42,615
Commitments:						
Documentary credits and short-term trade-related transactions	**49,367**	**19,374**	**10,217**	49,414	19,147	9,714
Undrawn note issuing and revolving underwriting facilities	**1,166**	**583**	**–**	3,249	1,625	975
Undrawn formal standby facilities, credit lines and other commitments:						
– one year and over	**67,856**	**33,928**	**29,888**	68,341	34,171	26,557
– under one year	**709,325**	**–**	**–**	615,856	–	–
	827,714	**53,885**	**40,105**	736,860	54,943	37,246

The tables above give the nominal contract amounts, credit equivalent and risk-weighted amounts of contingent liabilities and commitments. In accordance with the Third Schedule of the Hong Kong Banking Ordinance (the 'Third Schedule'), contingent liabilities and commitments are credit-related instruments that include acceptances and endorsements, letters of credit, guarantees and commitments to extend credit. The risk involved is essentially the same as the credit risk involved in extending loan facilities to customers.

The contract amounts represent the amounts at risk should the contract be fully drawn upon and the clients default. Since a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements. The risk-weighted amounts are assessed in accordance with the Third Schedule on capital adequacy and depend on the status of the counterparty and the maturity characteristics. The risk weights used range from 0% to 100%.

For the purpose of these financial statements, acceptances and endorsements are recognised on the balance sheet in 'Other assets' and 'Other liabilities' in accordance with HKAS 39. For the purpose of the Third Schedule, these acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies.

No netting agreements have been taken into account when arriving at the above amounts.

b *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.

43 Assets pledged as security for liabilities

Liabilities of the group amounting to HK$52,244 million *(2005: HK$42,887 million)* and of the Bank amounting to HK$27,554 million *(2005: HK$22,664 million)* 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$58,807 million *(2005: HK$50,647 million)* and by the Bank is HK$32,803 million *(2005: HK$29,922 million)*. These assets comprise treasury bills, debt securities and deposits.

In respect of reverse repo and stock borrowing transactions, the fair value of collateral held by the group which were permitted to be sold or repledged amounted to HK$91,206 million *(2005: HK$79,490 million)*, and by the Bank of HK$83,302 million *(2005: HK$68,667 million)*. The fair value of such collateral actually sold or repledged by the group amounted to HK$40,549 million *(2005: HK$40,405 million)* and by the Bank of HK$32,646 million *(2005: HK$29,581 million)*.

44 Capital commitments

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**4,459**	1,979	**3,333**	303
Expenditure authorised by the Directors but not contracted for	**116**	67	**116**	60
	4,575	2,046	**3,449**	363

The capital commitments mainly relate to the commitment to purchase premises and equipment as well as to increase the investment in the HSBC Private Equity Fund 3 Limited which has committed to make private equity investments in Asian companies that are seeking capital to expand existing operations or fund management buy-outs.

45 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*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**1,494**	1,224	**1,016**	884
– five years or less but over one year	**2,374**	1,845	**1,413**	1,086
– over five years	**180**	193	**135**	180
	4,048	3,262	**2,564**	2,150
Equipment				
Amounts payable within				
– one year or less	**58**	52	**33**	37
– five years or less but over one year	**138**	166	**75**	123
– over five years	**–**	–	**–**	–
	196	218	**108**	160

46 Segmental analysis

Segmental information is presented in respect of the group's geographical and business segments. Geographical segment information is chosen as the primary reporting format as this aligns more closely with the group's internal financial reporting.

a *By geographical region*

The allocation of earnings reflects the benefits of shareholders' funds to the extent that these are actually allocated to businesses in the segment by way of intra-group capital and funding structures.

Interest is charged based on market rates. Common costs are included in segments on the basis of the actual recharges made. Geographical information has been classified by the location of the principal operations of the subsidiary company or, in the case of the Bank, by the location of the branch responsible for reporting the results or advancing the funds. Due to the nature of the group structure, the analysis of profits shown below includes intra-group items between geographical regions with the elimination shown in a separate column.

Total assets:

	2006		2005	
	HK$m	**%**	HK$m	%
Hong Kong	**2,180,154**	**69.2**	1,870,122	70.0
Rest of Asia-Pacific	**954,567**	**30.3**	796,383	29.8
Americas/Europe	**16,119**	**0.5**	6,027	0.2
Total assets	**3,150,840**	**100.0**	2,672,532	100.0

Total liabilities:

	2006		2005	
	HK$m	**%**	HK$m	%
Hong Kong	**2,076,174**	**69.6**	1,786,985	69.9
Rest of Asia-Pacific	**893,304**	**29.9**	765,288	29.9
Americas/Europe	**15,917**	**0.5**	5,834	0.2
Total liabilities	**2,985,395**	**100.0**	2,558,107	100.0

Net assets:

	2006		2005	
	HK$m	**%**	HK$m	%
Hong Kong	**103,980**	**62.9**	83,137	72.7
Rest of Asia-Pacific	**61,263**	**37.0**	31,095	27.2
Americas/Europe	**202**	**0.1**	193	0.1
	165,445	**100.0**	114,425	100.0

Minority interests are included in the above table.

Capital additions during the year:

	2006		2005	
	HK$m	**%**	HK$m	%
Hong Kong	**2,543**	**57.7**	1,884	78.6
Rest of Asia-Pacific	**1,863**	**42.3**	514	21.4
	4,406	**100.0**	2,398	100.0

46 Segmental analysis *(continued)*

Investment in associates and joint venture:

	2006		2005	
	HK$m	**%**	HK$m	%
Hong Kong	**992**	**3.9**	840	3.6
Rest of Asia-Pacific	**24,542**	**96.1**	22,221	96.4
	25,534	**100.0**	23,061	100.0

Credit commitments (contract amounts):

	2006		2005	
	HK$m	**%**	HK$m	%
Hong Kong	**655,313**	**57.4**	599,908	60.5
Rest of Asia-Pacific	**485,505**	**42.6**	391,898	39.5
	1,140,818	**100.0**	991,806	100.0

Notes on the Financial Statements (continued)

46 Segmental analysis *(continued)*

Consolidated income statement:

2006	*Hong Kong* **HK$m**	*Rest of Asia-Pacific* **HK$m**	*Americas/ Europe* **HK$m**	*Intra-segment elimination* **HK$m**	*Total* **HK$m**
Interest income from third parties and fellow subsidiaries	77,534	37,740	654	–	115,928
Inter-segment interest income	4,767	2,411	230	(7,408)	–
Interest income	82,301	40,151	884	(7,408)	115,928
Interest expense to third parties and fellow subsidiaries	(43,863)	(20,381)	(585)	–	(64,829)
Inter-segment interest expense	(2,627)	(4,579)	(219)	7,425	–
Interest expense	(46,490)	(24,960)	(804)	7,425	(64,829)
Net interest income	35,811	15,191	80	17	51,099
Fee income	17,347	9,925	–	(718)	26,554
Fee expense	(3,030)	(1,826)	(12)	718	(4,150)
Net trading income/(loss)	3,077	5,871	(13)	(17)	8,918
Net income from financial instruments designated at fair value	2,048	622	–	–	2,670
Gains less losses from financial investments	1,245	221	–	–	1,466
Dividend income	525	224	–	–	749
Net earned insurance premiums	20,495	1,351	–	–	21,846
Other operating income	6,171	2,073	22	(2,613)	5,653
Total operating income	83,689	33,652	77	(2,613)	114,805
Net insurance claims incurred and movement in policyholders' liabilities	(20,991)	(1,489)	–	–	(22,480)
Net operating income before loan impairment charges and other credit risk provisions	62,698	32,163	77	(2,613)	92,325
Loan impairment charges and other credit risk provisions	(1,336)	(3,473)	–	–	(4,809)
Net operating income	61,362	28,690	77	(2,613)	87,516
Operating expenses	(23,534)	(17,287)	(31)	2,613	(38,239)
Operating profit	37,828	11,403	46	–	49,277
Share of profit in associates and joint venture	150	2,589	–	–	2,739
Profit before tax	37,978	13,992	46	–	52,016
Tax expense	(6,079)	(3,317)	(15)	–	(9,411)
Profit for the year	31,899	10,675	31	–	42,605
Profit attributable to shareholders	27,206	10,472	31	–	37,709
Profit attributable to minority interests	4,693	203	–	–	4,896
Net operating income before loan impairment					
– external	59,877	31,541	(135)	–	91,283
– inter-company/inter-segment	2,821	622	212	(2,613)	1,042
Depreciation and amortisation included in operating expenses	(1,720)	(527)	(1)	–	(2,248)

46 Segmental analysis *(continued)*

2005	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Americas/ Europe HK$m	Intra-segment elimination HK$m	Total HK$m
Interest income from third parties and fellow subsidiaries	51,641	28,323	235	–	80,199
Inter-segment interest income	3,498	1,290	294	(5,082)	–
Interest income	55,139	29,613	529	(5,082)	80,199
Interest expense to third parties and fellow subsidiaries	(22,421)	(14,088)	(199)	–	(36,708)
Inter-segment interest expense	(1,728)	(3,248)	(106)	5,082	–
Interest expense	(24,149)	(17,336)	(305)	5,082	(36,708)
Net interest income	30,990	12,277	224	–	43,491
Fee income	14,237	7,921	2	(489)	21,671
Fee expense	(2,252)	(1,803)	(8)	489	(3,574)
Net trading income/(loss)	3,152	4,198	(170)	–	7,180
Net income/(loss) from financial instruments designated at fair value	(69)	453	–	–	384
Gains less losses from financial investments	714	42	–	–	756
Dividend income	350	18	–	–	368
Net earned insurance premiums	18,140	1,200	–	–	19,340
Other operating income	6,480	1,131	22	(2,736)	4,897
Total operating income	71,742	25,437	70	(2,736)	94,513
Net insurance claims incurred and movement in policyholders' liabilities	(16,002)	(1,289)	–	–	(17,291)
Net operating income before loan impairment charges and other credit risk provisions	55,740	24,148	70	(2,736)	77,222
Loan impairment charges and other credit risk provisions	(1,161)	(915)	12	–	(2,064)
Net operating income	54,579	23,233	82	(2,736)	75,158
Operating expenses	(20,514)	(13,998)	(38)	2,736	(31,814)
Operating profit	34,065	9,235	44	–	43,344
Share of profit in associates and joint venture	178	1,727	–	–	1,905
Profit before tax	34,243	10,962	44	–	45,249
Tax expense	(5,411)	(2,634)	(6)	–	(8,051)
Profit for the year	28,832	8,328	38	–	37,198
Profit attributable to shareholders	24,644	8,191	38	–	32,873
Profit attributable to minority interests	4,188	137	–	–	4,325
Net operating income before loan impairment					
– external	53,215	24,570	(186)	–	77,599
– inter-company/inter-segment	2,525	(422)	256	(2,736)	(377)
Depreciation and amortisation included in operating expenses	(1,487)	(495)	(1)	–	(1,983)

Notes on the Financial Statements (continued)

46 Segmental analysis *(continued)*

b *By customer group*

The group comprises five major customer groups. Personal Financial Services provides financial services to individuals, including self employed individuals (but excluding individuals managed by Private Banking). Commercial Banking manages relationships with small and medium sized corporates. Corporate, Investment Banking and Markets includes the relationships with large corporate and institutional customers together with the group's treasury and investment banking operations. Private Banking provides financial services to high net worth individuals, who have complex financial affairs. Due to the nature of the HSBC Group structure, the majority of HSBC's Private Banking business in Hong Kong and the rest of Asia-Pacific is not included within The Hongkong and Shanghai Banking Corporation group. Other mainly represents investments in premises, investment properties and shareholders' funds to the extent that they have not been allocated to the other business segments. In addition, a number of income and expense items include the effect of financial transactions entered into in the ordinary course of business between customer groups. The analysis below includes inter-segment amounts within each customer group with the elimination shown in a separate column.

Revenue is allocated to individual segments where they are clearly attributable to that segment. Transactions between segments are reported using appropriate transfer pricing agreements which are on normal commercial terms.

Operating expenses are allocated to individual segments where:

(a) they are clearly attributable to that segment (for example, rent, staff costs for employees of that segment, etc); and

(b) where they are allocations of certain central costs and support services, which are made on a basis which is designed broadly to reflect the utilisation of such resources by each segment.

46 Segmental analysis *(continued)*

2006	*Personal Financial Services* HK$m	*Commercial Banking* HK$m	*Corporate, Investment Banking and Markets* HK$m	*Private Banking* HK$m	*Other* HK$m	*Intra-segment elimination* HK$m	*Total* HK$m
Net interest income/(expense)	**30,090**	**14,006**	**9,104**	**45**	**(4,201)**	**2,055**	**51,099**
Net fee income/(expense)	**10,512**	**5,018**	**6,937**	**101**	**(164)**	**–**	**22,404**
Net trading income	**889**	**796**	**8,682**	**14**	**825**	**(2,288)**	**8,918**
Net income/(loss) from financial instruments designated at fair value	**3,364**	**(384)**	**74**	**(1)**	**(616)**	**233**	**2,670**
Gains less losses from financial investments	**108**	**–**	**226**	**–**	**1,132**	**–**	**1,466**
Dividend income	**9**	**10**	**55**	**–**	**675**	**–**	**749**
Net earned insurance premiums	**20,741**	**972**	**133**	**–**	**–**	**–**	**21,846**
Other operating income	**2,262**	**348**	**430**	**14**	**7,005**	**(4,406)**	**5,653**
Total operating income	**67,975**	**20,766**	**25,641**	**173**	**4,656**	**(4,406)**	**114,805**
Net insurance claims incurred and movement in policyholders' Liabilities	**(21,902)**	**(478)**	**(100)**	**–**	**–**	**–**	**(22,480)**
Net operating income before loan impairment charges and other credit risk provisions	**46,073**	**20,288**	**25,541**	**173**	**4,656**	**(4,406)**	**92,325**
Loan impairment charges and other credit risk provisions	**(4,528)**	**(446)**	**250**	**–**	**(85)**	**–**	**(4,809)**
Net operating income	**41,545**	**19,842**	**25,791**	**173**	**4,571**	**(4,406)**	**87,516**
Operating expenses	**(19,913)**	**(6,531)**	**(11,219)**	**(167)**	**(4,815)**	**4,406**	**(38,239)**
Operating profit/(loss)	**21,632**	**13,311**	**14,572**	**6**	**(244)**	**–**	**49,277**
Share of profit in associates and joint venture	**257**	**1,634**	**671**	**–**	**177**	**–**	**2,739**
Profit/(loss) before tax	**21,889**	**14,945**	**15,243**	**6**	**(67)**	**–**	**52,016**
Net operating income before loan impairment							
– external	**15,220**	**14,905**	**54,848**	**(39)**	**6,349**	**–**	**91,283**
– inter-company/inter-segment	**30,853**	**5,383**	**(29,307)**	**212**	**(1,693)**	**(4,406)**	**1,042**
Segment assets	**650,553**	**341,298**	**2,074,430**	**3,378**	**404,484**	**(348,837)**	**3,125,306**
Investments in associates and joint venture	**2,224**	**14,584**	**5,904**	**–**	**2,822**	**–**	**25,534**
Total assets	**652,777**	**355,882**	**2,080,334**	**3,378**	**407,306**	**(348,837)**	**3,150,840**
Net assets	**34,599**	**28,967**	**56,117**	**157**	**45,605**	**–**	**165,445**
Capital additions during the year	**305**	**47**	**1,241**	**–**	**2,813**	**–**	**4,406**

Notes on the Financial Statements (continued)

46 Segmental analysis *(continued)*

2005	*Personal Financial Services* HK$m	*Commercial Banking* HK$m	*Corporate, Investment Banking and Markets* HK$m	*Private Banking* HK$m	*Other* HK$m	*Intra-segment elimination* HK$m	*Total* HK$m
Net interest income/(expense)	26,801	11,089	8,725	63	(3,800)	613	43,491
Net fee income	8,050	4,524	5,388	55	80	–	18,097
Net trading income/(loss)	683	638	7,215	10	(582)	(784)	7,180
Net income/(loss) from financial instruments designated at fair value	666	(648)	122	–	73	171	384
Gains less losses from financial investments	–	23	19	–	714	–	756
Dividend income	5	14	167	–	182	–	368
Net earned insurance premiums	18,437	756	147	–	–	–	19,340
Other operating income	1,984	295	572	13	6,338	(4,305)	4,897
Total operating income	56,626	16,691	22,355	141	3,005	(4,305)	94,513
Net insurance claims incurred and movement in policyholders' Liabilities	(16,889)	(330)	(72)	–	–	–	(17,291)
Net operating income before loan impairment charges and other credit risk provisions	39,737	16,361	22,283	141	3,005	(4,305)	77,222
Loan impairment charges and other credit risk provisions	(1,344)	(896)	165	–	11	–	(2,064)
Net operating income	38,393	15,465	22,448	141	3,016	(4,305)	75,158
Operating expenses	(16,932)	(5,424)	(9,642)	(113)	(4,008)	4,305	(31,814)
Operating profit/(loss)	21,461	10,041	12,806	28	(992)	–	43,344
Share of profit in associates and joint venture	179	1,090	446	–	190	–	1,905
Profit/(loss) before tax	21,640	11,131	13,252	28	(802)	–	45,249
Net operating income before loan impairment							
– external	19,981	12,543	40,749	95	4,231	–	77,599
– inter-company/inter-segment	19,756	3,818	(18,466)	46	(1,226)	(4,305)	(377)
Segment assets	602,268	289,360	1,756,091	3,262	324,006	(325,516)	2,649,471
Investments in associates and joint ventures	2,048	13,418	5,406	–	2,189	–	23,061
Total assets	604,316	302,778	1,761,497	3,262	326,195	(325,516)	2,672,532
Net assets	20,314	18,464	31,295	85	44,267	–	114,425
Capital additions during the year	318	73	32	–	1,975	–	2,398

47 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).

Transactions with the immediate holding company included the issuance of preference shares and the payment of interest on preference shares. As at 31 December 2006, the Bank has issued HK$76,464 million of preference shares to its immediate holding company (*2005: HK$48,873 million*). 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 2006, the Bank has issued HK$2,125 million of subordinated liabilities to its ultimate holding company (*2005: HK$2,106 million*). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		*Ultimate holding company*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**3,653**	2,344	**115**	12
Other operating income	**–**	–	**37**	10
Other operating expenses	**48**	–	**999**	674

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 4b), preference shares issued (note 35).

Interest expense on subordinated liabilities amounted to HK$115 million for the year (*2005: HK$12 million*). Information relating to subordinated liabilities can be found in note 34.

Balances at 31 December

Group

	Immediate holding company		*Ultimate holding company*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**–**	–	**–**	1
Amounts due to[1]	**78,992**	50,296	**2,489**	2,502

Bank

	Immediate holding company		*Ultimate holding company*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**–**	–	**–**	1
Amounts due to[1]	**78,992**	50,296	**2,439**	2,477

1 *Amounts due to the immediate holding company included preference shares of HK$76,464 million. As at 31 December 2006, all preference shares were held by the immediate holding company. As at 31 December 2005, preference shares of HK$48,873 million were held by the immediate holding company and HK$23,107 million were held by a fellow subsidiary company.*

Amounts due to the ultimate holding company included subordinated liabilities of HK$2,125 million (2005: HK$2,106 million).

Guarantees made by the ultimate holding company on behalf of the group amounted to HK$12,126 million *(2005: HK$10,811 million).*

Notes on the Financial Statements (continued)

47 Related-party transactions *(continued)*

Share option schemes

The group participates in various share option plans operated by HSBC Holdings plc whereby share options 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. The cost borne by the ultimate holding company in respect of these share options is treated as a capital contribution and is recorded under 'Other reserves'. The balance of this reserve as at 31 December 2006 amounted to HK$1,082 million *(2005: HK$629 million)*.

b *Subsidiaries and fellow subsidiaries*

In 2006, the group entered into transactions with its fellow subsidiary companies 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 priced at the relevant market rates at the time of the transactions.

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 subsidiary companies and paid professional service fees on certain structured finance deals to a fellow subsidiary company. 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	
	2006	2005
	HK$m	HK$m
Interest income	**4,480**	1,688
Interest expense[1]	**1,545**	920
Fee income	**1,237**	718
Fee expense	**680**	448
Other operating income	**1,175**	839
Other operating expenses[2]	**2,988**	1,225

1 *2006 included interest on preference shares of HK$859 million (2005: HK$666 million).*
2 *2006 included payment of HK$704 million (2005: HK$472 million) of software costs which were capitalised as intangible assets in the balance sheet of the group.*

Balances at 31 December

Group

	Fellow subsidiaries	
	2006	2005
	HK$m	HK$m
Amounts due from	**161,118**	101,172
Amounts due to[1]	**26,339**	43,959

Bank

	Subsidiaries		*Fellow subsidiaries*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**28,521**	23,571	**140,596**	96,405
Amounts due to[1]	**20,125**	20,773	**22,509**	40,853

1 *In 2005, amounts due to fellow subsidiaries included preference shares of HK$23,107 million. As at 31 December 2006, all preference shares were held by the immediate holding company.*

47 Related-party transactions *(continued)*

c *Associates and joint venture*

Information relating to associates and joint venture can be found in note 20 where the following are disclosed:

– investments in associates and joint venture;

– amounts due from/to associates and joint venture;

– principal associates.

The Bank has entered into a Technical Support and Assistance Agreement with Bank of Communications (BoCom) to provide technical support and assistance in relation to the banking business of BoCom. The Bank has continued to assist BoCom in growing the credit card division and has provided technical support in the issuing of co-branded credit cards with HSBC.

d *Key management personnel*[1]

Key management compensation

	2006	2005
	HK$m	HK$m
Salaries and other short-term benefits	**163**	138
Post-employment benefits	**9**	9
Share-based payments	**51**	39
	223	186

1 *Key management personnel are the Board of Directors of HSBC Holdings plc and the Board of Directors and executive committee members of The Hongkong and Shanghai Banking Corporation Ltd.*

In May 2006, the Group Chairman of HSBC Holdings plc, Sir John Bond, was succeeded by S K Green, formerly Group Chief Executive. M F Geoghegan in turn succeeded S K Green as Group Chief Executive. Their remuneration for services rendered to the HSBC Group as a whole, is included in the financial statements of HSBC Holdings plc. No separate charge is made to the Bank or the group in respect of any remuneration for directors of HSBC Holdings plc.

In addition to their salaries, the group also provides non-cash benefits including share-based payments to directors and executive officers, and contributes to post-employment benefits on their behalf (see note 4o regarding directors' emoluments).

Transactions, arrangements and agreements involving key management personnel

Particulars of transactions, arrangements and agreements 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 were as follows:

	2006	2005
	HK$m	HK$m
Average assets	**22,278**	23,474
Average liabilities	**12,516**	12,569

The aggregate contribution to the group's profit before tax from such transactions in 2006 was HK$503 million (*2005: HK$536 million*). As at the balance sheet date, guarantees made on behalf of such companies were HK$3,116 million (*2005: HK$541 million*).

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 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.

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

Notes on the Financial Statements (continued)

47 Related-party transactions *(continued)*

Loans to officers

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*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
By the Bank	**169**	187	**209**	216
By subsidiary companies	**–**	–	**23**	10
	169	187	**232**	226

e *Pension funds*

At 31 December 2006, HK$13.0 billion *(2005: HK$11.7 billion)* of pension fund assets were under management by a wholly owned subsidiary. Fees of HK$5 million (*2005: HK$5 million*) were earned by the group company for providing these management services.

48 Capital adequacy ratios

The group's capital adequacy ratios adjusted for market risks calculated in accordance with the Hong Kong Monetary Authority Guideline on 'Maintenance of Adequate Capital Against Market Risks' are as follows:

	2006	2005
Total capital	**13.5%**	12.4%
Tier 1 capital	**12.3%**	11.7%

The group's capital adequacy ratios calculated in accordance with the provisions of the Third Schedule of the Banking Ordinance, which does not take into account market risk are as follows:

Total capital	**13.0%**	12.0%
Tier 1 capital	**11.8%**	11.2%

49 Liquidity ratio

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

The average liquidity ratio for the year were as follows:

	2006	2005
Hong Kong branches of the Bank	**49.3%**	48.2%

50 Share-based payments

HSBC operates both share option schemes and share award schemes. These are to be settled by the delivery of shares of HSBC Holdings plc.

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 value of share options, measured at the date of grant of the option, is 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 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.

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

2006	*1-year Savings-Related Share Option Schemes*	*3-year Savings-Related Share Option Schemes*	*5-year Savings-Related Share Option Schemes*
Risk-free interest rate[1] (%)	**4.7**	**4.8**	**4.7**
Expected life[2] (years)	**1**	**3**	**5**
Expected volatility[3] (%)	**17**	**17**	**17**

2005	*3-year Savings-Related Share Option Schemes*	*5-year Savings-Related Share Option Schemes*
Risk-free interest rate[1] (%)	4.3	4.3
Expected life[2] (years)	3	5
Expected volatility[3] (%)	20	20

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 historic 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 Group Share Option Plan, Executive Share Option Scheme and Savings-Related Share Option Plans.

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

The Executive Share Option Scheme and Group Share Option Plan were long-term incentive schemes under which certain HSBC employees between 1993 and 2005 were awarded share options. 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.

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

The Executive Share Option Scheme ('ESOS') ran from October 1993 until April 2000, after which it was replaced by the Group Share Option Plan ('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;
- the exercise price of the option was equal to the share price at the date of grant and the options are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions.

After consideration of the performance and shareholder returns over the period between 2003 and 2005, Group Remuneration Committee exercised its discretion to waive the Total Shareholder Return performance condition in respect of the awards made under this plan in 2003.

As a result, a charge of HK$188 million was recognised, reflecting the incremental fair value granted measured at the date the performance condition was waived. This was measured using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model, as described above in 'Calculation of fair value'. A risk-free interest rate of 4.3 per cent was used, with all other inputs to the model consistent with those used to value the other share options and awards made during 2006.

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

	2006		2005	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000)	**GBP**	(000)	GBP
Outstanding at 1 January	**31,908**	**7.79**	35,808	7.77
Exercised in the year	**(4,831)**	**7.53**	(2,705)	7.55
Lapsed in the year	**(2,656)**	**7.79**	(1,195)	7.59
Outstanding at 31 December	**24,421**	**7.84**	31,908	7.79
Exercisable at 31 December	**16,744**	**7.63**	16,677	7.62

Bank

	2006		2005	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000)	**GBP**	(000)	GBP
Outstanding at 1 January	**24,157**	**7.79**	26,876	7.77
Exercised in the year	**(3,395)**	**7.52**	(1,971)	7.57
Lapsed in the year	**(1,852)**	**7.92**	(748)	7.87
Outstanding at 31 December	**18,910**	**7.82**	24,157	7.79
Exercisable at 31 December	**13,167**	**7.62**	12,755	7.62

The options outstanding at the year end had an exercise price in the range of GBP5.02 to GBP8.71 (*2005: GBP3.33 to GBP8.71*), and a weighted average remaining contractual life of 5.51 years (*2005: 6.40 years*).

50 Share-based payments *(continued)*

The weighted average share price during the year was GBP9.59 (*2005: GBP8.89*).

No awards have been made under this plan since 2005.

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 GBP250 per month, with the option to use the savings to acquire shares. To encourage greater participation in the scheme, two amendments were made in 2006. The first was the introduction of the facility to save and have option prices expressed in US dollars, Hong Kong dollars and euros as well as in pounds sterling. The second amendment gives individuals the choice to enter into savings contracts of one year in addition to three and five-year terms.

The options are 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 depending on conditions set at grant. There is generally one Sharesave grant each year (in April or May). The exercise price is at a 20 per cent (*2005: 20 per cent*) discount to the market value at the date of grant.

The employee has the right to withdraw their accumulated savings and withdraw from the plan at any time. Upon voluntary withdrawal, any remaining unamortised compensation expense is recognised in the current period.

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:

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

Group

	2006		2005	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000)	**GBP**	(000)	GBP
Outstanding at 1 January	**28,360**	**6.12**	31,297	5.93
Granted in the year	**1,321**	**7.67**	9,750	6.68
Forfeited/expired in the year	**(2,052)**	**6.26**	(1,632)	6.06
Exercised in the year	**(8,110)**	**5.44**	(11,055)	6.07
Outstanding at 31 December	**19,519**	**6.49**	28,360	6.12
Exercisable at 31 December	**111**	**5.43**	82	6.13

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

Bank

	2006		2005	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000)	**GBP**	(000)	GBP
Outstanding at 1 January	**20,453**	**6.12**	22,915	5.92
Granted in the year	**1,161**	**7.67**	7,662	6.68
Forfeited/expired in the year	**(1,435)**	**6.25**	(1,093)	6.09
Exercised in the year	**(5,673)**	**5.45**	(9,031)	6.07
Outstanding at 31 December	**14,506**	**6.49**	20,453	6.12
Exercisable at 31 December	**75**	**5.42**	78	6.13

The options outstanding at the year end had an exercise price in the range of GBP5.35 to GBP7.67 (*2005: GBP5.35 to GBP6.75*), and a weighted average remaining contractual life of 2.15 years (*2005: 2.48 years*).

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

	Group		*Bank*	
	2006		**2006**	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000)	**HK$**	**(000)**	**HK$**
Granted in the year	**6,378**	**103.44**	**4,360**	**103.44**
Forfeited in the year	**(65)**	**103.44**	**(38)**	**103.44**
Outstanding at 31 December	**6,313**	**103.44**	**4,322**	**103.44**

No options are exercisable at the end of the year.

The options outstanding at the year end had an exercise price of HK$103.44, and a weighted average remaining contractual life of 2.99 years.

The weighted average share price at the date of exercise for share options exercised during the year was GBP9.54 (*2005: GBP9.29*).

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

50 Share-based payments *(continued)*

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.

a *Performance Share Awards*

Performance share awards are made to the group's most senior executives taking into account individual performance in the prior year. The share awards are divided into two equal parts for testing attainment against predetermined benchmarking. One half is subject to a Total Shareholder Return ('TSR') measure and the other half of the award is subject to an Earnings Per Share ('EPS') target. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if HSBC performance fails to meet the minimum criteria. Additional awards will be made during the 3-year life of the award representing the equivalent value of dividends. At the end of three years, the original award together with the additional share awards will be released.

	Group		*Bank*	
	2006	2005	**2006**	2005
	Number	*Number*	*Number*	*Number*
	(000)	(000)	**(000)**	(000)
Outstanding at 1 January	**3,003**	2,801	**2,473**	2,205
Additions during the year	**786**	833	**658**	691
Released in the year	**(590)**	(559)	**(513)**	(390)
Lapsed in the year	**(107)**	(72)	**(88)**	(33)
Outstanding at 31 December	**3,092**	3,003	**2,530**	2,473

The weighted average remaining vesting period was 1.60 years (*2005: 2.22 years*).

The weighted average fair value of shares granted during the year with TSR conditions as at the year end was GBP4.76 (*2005: GBP5.30*) while shares with EPS conditions had a fair value of GBP9.31 (*2005: GBP9.33*) as at year end.

b *Restricted Share Awards*

Restricted share awards are made to eligible employees for recruitment and retention purposes or as part of deferral of annual bonus. The awards vest between one and three years from date of award.

	Group		*Bank*	
	2006	2005	**2006**	2005
	Number	*Number*	*Number*	*Number*
	(000)	(000)	**(000)**	(000)
Outstanding at 1 January	**5,348**	4,902	**5,183**	4,668
Additions during the year	**3,254**	3,380	**3,248**	3,358
Released in the year	**(2,340)**	(2,890)	**(2,212)**	(2,800)
Lapsed in the year	**(315)**	(44)	**(315)**	(43)
Outstanding at 31 December	**5,947**	5,348	**5,904**	5,183

The weighted average remaining vesting period as at year end was 1.61 years (*2005: 1.65 years*).

The closing price of HSBC Holdings shares on 29 December 2006 was GBP9.31 (*31 December 2005: GBP9.33*).

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

c *Achievement Share Awards*

Achievement shares 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 of 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 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*	
	2006	2005	**2006**	2005
	Number	*Number*	*Number*	*Number*
	(000)	(000)	**(000)**	(000)
Outstanding at 1 January	**661**	–	**537**	–
Granted in the year	**933**	674	**760**	548
Released in the year	**(1)**	–	**(1)**	–
Lapsed in the year	**(44)**	(13)	**(37)**	(11)
Outstanding at 31 December	**1,549**	661	**1,259**	537

The weighted average remaining vesting period as at year end was 1.83 years (*2005: 2.25 years*).

Employee expenses

The following amounts were recognised during the year in respect of share-based payment transactions:

	2006	2005
	HK$m	HK$m
Share options granted	**485**	333
Expense arising from cash-settled share-based payment transactions	**523**	543
Total expense recognised as employee costs	**1,008**	876
Total carrying amount of cash-settled transaction liabilities	**714**	576

51 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), and
- insurance 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 financial and other risks are systematically identified, measured, analysed and actively managed.

51 Risk Management *(continued)*

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. 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.

Both the HSBC Group and the Bank Executive Committees receive regular reports on credit exposures. These include information on large credit exposures, concentrations, industry exposures, levels of impairment provisioning and country exposures.

Within the group, the Chief Executive Officer and the Chief Credit Officer are responsible for the quality and performance of the group's credit portfolio and for monitoring and controlling all credit risks in the group's portfolios, including those which are subject to central approval by HSBC Group Head Office. This includes policies on collateral and customer vetting processes.

Notes on the Financial Statements (continued)

51 Risk Management *(continued)*

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. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfill their intended purpose and remain in line with local market practice. While collateral is an important mitigant to credit risk, it is the group's policy to establish that loans are within the customer's capacity to repay rather than to rely excessively on security. In certain cases, depending on the customer's standing and the type of product, facilities may be unsecured. 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.

Other securities

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 following other pre-agreed termination events. It is also common 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.

Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. 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.

51 Risk Management *(continued)*

Maximum exposure to credit risk

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

Group

	2006	2005
	HK$m	HK$m
Cash and short-term funds	**518,022**	502,730
Items in the course of collection from other banks	**46,519**	17,782
Placings with banks maturing after one month	**104,037**	69,554
Certificates of deposit	**73,200**	53,831
Hong Kong SAR Government certificates of indebtedness	**102,374**	97,344
Trading assets	**338,792**	215,681
Debt securities	**140,252**	108,687
Equity shares	**23,101**	22,677
Treasury bills	**152,816**	69,880
Other	**22,623**	14,437
Financial assets designated at fair value	**50,514**	37,073
Debt securities	**22,939**	15,070
Treasury bills	**–**	94
Equity shares	**27,159**	18,320
Other	**416**	3,589
Derivatives	**99,167**	72,039
Advances to customers	**1,043,782**	999,326
Financial investments	**484,841**	394,497
Debt securities	**445,260**	378,726
Equity shares	**39,581**	15,771
Amounts due from group companies	**161,118**	101,173
Other assets	**53,150**	41,873
Acceptances and endorsements	**26,729**	22,744
Other	**26,421**	19,129
Financial guarantees and other credit related contingent liabilities	**100,999**	83,151
Loan commitments and other credit related commitments	**1,150,033**	993,557
At 31 December	**4,326,548**	3,679,611

Notes on the Financial Statements (continued)

51 Risk Management *(continued)*

Bank

	2006	2005
	HK$m	HK$m
Cash and short-term funds	**426,176**	430,129
Items in the course of collection from other banks	**40,434**	9,705
Placings with banks maturing after one month	**79,249**	53,205
Certificates of deposit	**33,907**	23,001
Hong Kong SAR Government certificates of indebtedness	**102,374**	97,344
Trading assets	**284,057**	173,169
Debt securities	**103,565**	80,246
Equity shares	**20,816**	22,008
Treasury bills	**146,744**	67,286
Other	**12,932**	3,629
Financial assets designated at fair value	**11,182**	8,755
Debt securities	**10,766**	5,166
Other	**416**	3,589
Derivatives	**97,834**	70,328
Advances to customers	**686,468**	664,645
Financial investments	**243,223**	196,684
Debt securities	**208,442**	184,325
Equity shares	**34,781**	12,359
Amounts due from group companies	**169,117**	119,977
Other assets	**42,808**	33,936
Acceptances and endorsements	**23,443**	20,197
Other	**19,365**	13,739
Financial guarantees and other credit related contingent liabilities	**93,108**	85,828
Loan commitments and other credit related commitments	**901,697**	802,430
At 31 December	**3,211,634**	2,769,136

Note 16b shows the analysis of advances to customers by industry sector and by geographical region.

51 Risk Management *(continued)*

Credit quality

Distribution of advances by credit quality

Group

	At 31 December 2006		At 31 December 2005	
	Advances to customers	*Advances to banks*	*Advances to customers*	*Advances to banks*
	HK$m	**HK$m**	HK$m	HK$m
Loans and advances				
– neither past due nor impaired	**1,028,909**	**501,163**	987,603	413,122
– past due but not impaired	**13,115**	**563**	11,300	170
– impaired	**8,601**	**–**	6,999	–
	1,050,625	**501,726**	1,005,902	413,292

Bank

	At 31 December 2006		At 31 December 2005	
	Advances to customers	*Advances to banks*	*Advances to customers*	*Advances to banks*
	HK$m	**HK$m**	HK$m	HK$m
Loans and advances				
– neither past due nor impaired	**674,068**	**389,633**	655,028	333,677
– past due but not impaired	**11,274**	**262**	9,769	170
– impaired	**6,828**	**–**	5,196	–
	692,170	**389,895**	669,993	333,847

Notes on the Financial Statements (continued)

51 Risk Management *(continued)*

Distribution of advances neither past due nor impaired

Group

	At 31 December 2006		At 31 December 2005	
	Advances to customers	*Advances to banks*	*Advances to customers*	*Advances to banks*
	HK$m	**HK$m**	HK$m	HK$m
Grades:				
1 to 3 – satisfactory risk	**993,045**	**499,923**	944,475	412,928
4 – watch list and special mention	**31,947**	**1,061**	37,084	91
5 – sub-standard but not impaired	**3,917**	**179**	6,044	103
	1,028,909	**501,163**	987,603	413,122

Bank

	At 31 December 2006		At 31 December 2005	
	Advances to customers	*Advances to banks*	*Advances to customers*	*Advances to banks*
	HK$m	**HK$m**	HK$m	HK$m
Grades:				
1 to 3 – satisfactory risk	**645,262**	**388,423**	618,312	333,483
4 – watch list and special mention	**25,687**	**1,031**	31,388	91
5 – sub-standard but not impaired	**3,119**	**179**	5,328	103
	674,068	**389,633**	655,028	333,677

- Grades 1 and 2 include corporate facilities demonstrating financial condition, risk factors and capacity to repay that are good to excellent, residential mortgages with low to moderate loan to value ratios, and other retail accounts which are not impaired and are maintained within product guidelines.
- Grade 3 represents satisfactory risk and includes corporate facilities that require closer monitoring, mortgages with higher loan to value ratios than grades 1 and 2, all non-impaired credit card exposures, and other retail exposures which operate outside product guidelines without being impaired.
- Grades 4 and 5 include corporate facilities that require various degrees of special attention and retail exposures that are progressively between 30 and 90 days past due.

51 Risk Management *(continued)*

Debt securities and other bills by rating agency designation

Group

	At 31 December 2006		
	Treasury bills	*Debt securities*	*Total*
	HK$m	**HK$m**	**HK$m**
AAA	**88,616**	**85,789**	**174,405**
AA – to AA +	**117,990**	**302,815**	**420,805**
A – to A +	**47,085**	**219,544**	**266,629**
Lower than A –	**5,037**	**49,345**	**54,382**
Unrated	**2,810**	**24,158**	**26,968**
	261,538	**681,651**	**943,189**

	At 31 December 2005		
	Treasury bills	*Debt securities*	*Total*
	HK$m	HK$m	HK$m
AAA	63,121	91,085	154,206
AA – to AA +	23,700	221,382	245,082
A – to A +	84,415	185,730	270,145
Lower than A –	3,623	44,004	47,627
Unrated	567	14,113	14,680
	175,426	556,314	731,740

Bank

	At 31 December 2006		
	Treasury bills	*Debt securities*	*Total*
	HK$m	**HK$m**	**HK$m**
AAA	**88,576**	**47,023**	**135,599**
AA – to AA +	**111,183**	**167,573**	**278,756**
A – to A +	**46,822**	**87,911**	**134,733**
Lower than A –	**5,037**	**38,421**	**43,458**
Unrated	**2,732**	**15,752**	**18,484**
	254,350	**356,680**	**611,030**

	At 31 December 2005		
	Treasury bills	*Debt securities*	*Total*
	HK$m	HK$m	HK$m
AAA	62,990	54,499	117,489
AA – to AA +	23,700	98,849	122,549
A – to A +	77,091	95,381	172,472
Lower than A –	3,581	33,918	37,499
Unrated	517	10,091	10,608
	167,879	292,738	460,617

51 Risk Management *(continued)*

Impaired loans and advances

Special attention is paid to problem loans and appropriate action is initiated to protect the group's position on a timely basis and to ensure that loan impairment methodologies result in losses being recognised when they are incurred.

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 3d.

Analyses of impairment allowances at 31 December 2006 and the movement of such allowances during the year are disclosed in note 17.

Collateral and other credit enhancements obtained

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*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**401**	410	**198**	211
Commercial and industrial properties	**14**	20	**12**	18
Other assets	**28**	89	**7**	39
	443	519	**217**	268

b *Liquidity risk and funding management*

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.

Management of liquidity is carried out both at group and Bank level as well as in individual branches and subsidiaries. The group requires branches and subsidiaries to maintain a strong liquidity position and to manage the liquidity structure of their assets, liabilities and commitments so that cash flows are appropriately balanced and all funding obligations are met when due.

It is the responsibility of local management to ensure compliance with local regulatory and Executive Committee requirements. Liquidity is managed on a daily basis by local treasury functions, with the larger treasury sites providing support to smaller entities where required.

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

- projecting cash flows by major currency and a consideration of the level of liquid assets in relation thereto;
- maintenance of strong balance sheet liquidity ratios and ensuring compliance with both internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- monitoring of depositor concentration both in terms of overall funding mix and to avoid undue reliance on large individual depositors;
- maintenance of liquidity contingency plans. These plans include the identification of early indicators of liquidity stress conditions and actions which are to be taken to improve the liquidity position at this stage, together with the actions which the entity can take to maintain liquidity in a crisis situation while minimising the long-term impact on its business.

51 Risk Management *(continued)*

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's overall funding. The group places considerable importance on the stability of these deposits, which is achieved through the group's retail banking activities and by maintaining depositor confidence in the group's capital strength. Professional markets are accessed for the purposes of providing additional funding, maintaining a presence in local money markets and optimising asset and liability maturities. Although the contractual repayments of many customer accounts are on demand or at short notice, in practice short-term deposit balances remain stable as inflows and outflows broadly match.

A maturity analysis of assets and liabilities is disclosed in note 38, while an analysis of possible cash flows under contractual terms is disclosed in note 39.

Exposure to liquidity risk

The key measure used by the group for managing liquidity risk is the ratio of net liquid assets to customer liabilities. Generally, liquid assets comprise cash balances, short-term interbank deposits and highly rated debt securities available for immediate sale and for which a deep and liquid market exists. Net liquid assets are liquid assets less all wholesale market funds, and all funds provided by customers deemed to be professional, maturing in the next 30 days. The definition of a professional customer takes account of the size of the customer's total deposits. 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 subsidiary companies which are Authorised Institutions under the Banking Ordinance in Hong Kong. Details are disclosed in note 49. The ratio of the reported group net liquid assets to customer liabilities as at the reporting date and during the reporting period were as follows:

	2006	2005
	%	%
At 31 December	**21.4**	18.2
Average for the period	**17.6**	17.8
Maximum for the period	**21.4**	22.0
Minimum for the period	**14.2**	14.7

c *Market risk management*

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 Corporate, Investment Banking and Markets operation, 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.

51 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 (for the group, 99%). 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.

Fair value and price verification control

Where certain financial instruments are carried on the group's balance sheet at fair values, the valuation and the related price verification processes are subject to independent validation across the group. Financial instruments which are accounted for on a fair value basis include assets held in the trading portfolio, financial instruments designated at fair value, obligations relating to securities sold short, derivative financial instruments and available-for-sale securities.

The determination of fair values is therefore a significant element in the reporting of the group's Global Markets activities.

Responsibility for determining accounting policies and procedures governing valuation and validation ultimately rests with finance functions which report to the group Chief Financial Officer. All significant valuation policies, and any changes thereto, must be approved by senior finance management. The Finance functions have ultimate responsibility for the determination of fair values included in the financial statements, and for ensuring that the group's policies comply with all relevant accounting standards.

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.

51 Risk Management *(continued)*

The total VAR for Global Markets was as follows:

	Group		*Bank*	
	2006	2005	**2006**	2005
	HK$m	HK$m	**HK$m**	HK$m
Total VAR				
Year end	**185**	129	**154**	85
Average	**140**	438	**118**	285
Maximum	**223**	829	**178**	582
Minimum	**64**	69	**70**	69
Total interest rate VAR				
Year end	**179**	127	**152**	83
Average	**139**	438	**117**	284
Maximum	**213**	826	**170**	579
Minimum	**64**	71	**70**	69
Trading VAR				
Year end	**41**	31	**44**	33
Average	**35**	58	**34**	59
Maximum	**56**	113	**47**	112
Minimum	**23**	21	**23**	22
Foreign exchange trading VAR				
Year end	**10**	8	**10**	10
Average	**10**	23	**10**	23
Maximum	**29**	89	**32**	89
Minimum	**4**	3	**5**	3
Interest rate trading VAR				
Year end	**43**	32	**42**	33
Average	**35**	49	**34**	49
Maximum	**56**	113	**49**	112
Minimum	**22**	20	**22**	23
Equity trading VAR				
Year end	**42**	–	**42**	–
Average	**16**	–	**16**	–
Maximum	**42**	–	**42**	–
Minimum	**4**	–	**4**	–

Equity VAR is disclosed for the first time in 2006.

51 Risk Management *(continued)*

Non-trading

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

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

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

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

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

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

Structural foreign exchange exposure

The group's gross structural foreign currency 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$108,465 million (75 per cent of shareholders' funds) at 31 December 2006, an increase of HK$34,619 million from HK$73,846 million (76 per cent of shareholders' funds) at 31 December 2005. Gains or losses on structural foreign currency exposures are taken to reserves. The increase in structural foreign currency exposure is principally due to an increase in the valuation of the group's strategic long-term foreign currency equity investments.

51 Risk Management *(continued)*

The group had the following structural foreign currency exposures which exceeded 10 per cent of the total net structural exposure in all foreign currencies:

	Group	*Bank*
At 31 December 2006	**HK$m**	**HK$m**
Chinese renminbi	**54,960**	**31,265**
United States dollars	**15,886**	**11,842**

	Group	*Bank*
At 31 December 2005	HK$m	HK$m
Chinese renminbi	32,510	11,558
Indian rupees	7,979	6,763
United States dollars	11,780	10,366

Non-structural positions

The group had the following non-structural foreign currency positions which exceeded 10 per cent of the net non-structural positions in all foreign currencies:

Group

	United States dollars	*Singapore dollars*	*Brunei dollars*
At 31 December 2006	**HK$m**	**HK$m**	**HK$m**
Spot assets	**1,205,314**	**118,964**	**27,665**
Spot liabilities	**(1,222,334)**	**(140,566)**	**(107)**
Forward purchases	**2,222,005**	**168,534**	**24,949**
Forward sales	**(2,210,290)**	**(141,505)**	**(57,857)**
Net options position	**(132)**	**–**	**–**
	(5,437)	**5,427**	**(5,350)**

	United States dollars	*Singapore dollars*	*Brunei dollars*
At 31 December 2005	HK$m	HK$m	HK$m
Spot assets	1,229,340	107,578	5,523
Spot liabilities	(1,188,737)	(90,549)	(18,062)
Forward purchases	1,507,086	157,007	43
Forward sales	(1,558,902)	(161,647)	–
Net options position	3,361	–	–
	(7,852)	12,389	(12,496)

Bank

	United States dollars	*Singapore dollars*	*Brunei dollars*
	HK$m	**HK$m**	**HK$m**
At 31 December 2006	**(7,297)**	**5,429**	**(5,350)**
At 31 December 2005	(10,106)	12,388	(12,496)

51 Risk Management *(continued)*

d *Insurance risk*

The group underwrites both life and non-life insurance, principally in Hong Kong and Singapore. The principal insurance risk faced by the group is that the costs of claims combined with acquisition and administration costs may exceed the aggregate amount of premiums received and investment income, and there is inherent uncertainty in respect of the timing and amounts of claims. Market risk in the form of interest-rate risk and equity risk also arises in the insurance businesses within the investment portfolios, primarily when guaranteed investment return policies have been issued.

The principal division of life business is between unit linked and non-linked.

Non-linked life insurance products

Non-linked life insurance products typically provide guaranteed death benefit with a fixed level of premium which is determined at the time of policy issue. Some products also include a savings element, under which guaranteed surrender and maturity benefits may be provided. Most products of this type include arrangements whereby policyholders participate in the profits of the life fund by means of annual bonuses. Although prima facie this business entails significant market risk, this is managed in conjunction with other risks through the investment policy and adjustment to bonus rates. In practice this means that the majority of the market risk is borne by policyholders. The main risk associated with this product is the value of assigned assets falling below that required to support benefit payments. The group manages this risk by conducting regular actuarial investigations on the supportability of the bonus rates and setting market risk mandates to limit market risk exposure.

Unit-linked life insurance products

For unit-linked life insurance products, market risk is usually borne by policyholders. The principal risk retained by the group relates to expenses, although mortality and morbidity risks are also associated with these products and are managed through the application of the techniques set out below.

Claims risk management

The group manages its insurance risk in respect of cost of claims through underwriting limits, approval procedures for transactions that involve new products or that exceed set limits, pricing guidelines, reinsurance and monitoring of emerging issues. In addition a dedicated asset and liability management function monitors and controls market risk which is specific to the insurance businesses.

Asset and liability management

A key aspect of risk management for insurance business, and life insurance in particular, is the need actively to manage the assets in relation to the liabilities. Of particular importance for a number of lines of business is the need to match the expected cash flows from assets and liabilities, which in some cases can run for many years. It is generally not possible to achieve a complete matching of asset and liability cash flows for insurance businesses. This is partly because with annual premium contracts there are uncertain future cash flows yet to be received from policyholders and partly because some liability cash flows exceed the duration of the longest available dated fixed interest investments.

A sensitivity analysis illustrating the effect of changes in key assumptions on carrying amount of the group's insurance liabilities within the next financial year is set out in note 31a.

Financial assets held to back insurance liabilities are included within the various categories of assets on the balance sheet. The principal categories under which such assets are included are: "Financial investments" and "Financial assets designated at fair value".

51 Risk Management *(continued)*

Reinsurance

The group also uses reinsurance agreements to control its exposure to losses arising from catastrophes and concentrations of insurance risk in both the life and non-life business.

The group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sums insured, in line with HSBC Group policies and senior management judgment.

Credit risk arises when part of the insurance risk incurred by the group is assumed by reinsurers. The group applies minimum security requirements for acceptable reinsurance and only uses reinsurers that meet the group's credit rating standard.

Life insurance business

In general terms, mortality and morbidity risks are mitigated through reinsurance and medical underwriting. Lapse and surrender risks are mitigated by the setting of appropriate surrender values. Market risk is usually mitigated through a combination of asset and liability management, as described above, and the risk being shared with policyholders. In the case of unit-linked business, market risk is generally borne by policyholders. In the case of non-linked life business, the risk is shared with policyholders through the management of bonuses.

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

As described in note 3v, the group recognises an asset in respect of PVIF. The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2006 can be stress-tested to assess the ability of the book of life business to withstand adverse developments. A key feature of life insurance business is the importance of managing the assets, liabilities and risks in a coordinated fashion rather than individually. This reflects the greater interdependence of these three elements for life insurance than is generally the case for non-life insurance.

The table set out in note 21b shows the effect on the PVIF as at 31 December 2006 of reasonably possible changes in the main economic assumptions.

52 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 Group's web site at www.hsbc.com or may be obtained from 8 Canada Square, London E14 5HQ, United Kingdom.

53 Nature of business

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

54 Accounting standards issued but not yet effective

The HKICPA has issued a number of amendments to HKFRS and Interpretations which are not yet effective.

a. The group has applied the following during the year ended 31 December 2006, before they become mandatory:

   HKFRS 7 'Financial Instruments: Disclosures' has resulted in additional disclosures relating to financial instruments being included in the financial statements. Comparative figures have been added, or where appropriate, amended to comply with this Standard. This has had no impact on reported profits, assets, liabilities, equity or cash flows.

   HK(IFRIC) INT 9 'Reassessment of Embedded Derivatives' has had no material effect on the financial statements in the current or prior years.

   HK(IFRIC) INT 10 'Interim Financial Reporting and Impairment' has had no material effect on the financial statements in the current or prior years.

   HK(IFRIC) INT 11 'HKFRS 2 – Group and Treasury Share Transactions' has had no material effect on the financial statements in the current or prior years.

b. The group has not yet applied the 'Amendment to HKAS 1 – Capital Disclosures', which will be mandatory for accounting periods beginning on or after 1 January 2007. This will result in the group disclosing additional information about how it manages its capital resources in the financial statements for the year ending 31 December 2007.

55 Comparative figures

In addition to applying HKFRS 7, the group has reviewed the disclosures in the financial statements and has made a number of presentational changes in certain note disclosures. In such cases, comparative figures in the notes have been amended to ensure consistency with the current year. None of these changes affect any line items in the Income Statement or the Balance Sheet. In addition, the group has presented a Consolidated Statement of Recognised Income and Expense in the current year to replace the Consolidated Statement of Changes in Equity which was presented in the 2005 financial statements.

56 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 5 March 2007.

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

We have audited the consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited set out on pages 21 to 156, which comprise the consolidated and the Bank's balance sheets as at 31 December 2006, and the consolidated income statement, consolidated statement of recognised income and expense and consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors of the Bank are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on these 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements 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 principles used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the 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 2006 and of the profit and cash flows of the group 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
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Central
Hong Kong

5 March 2007

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