# 2007

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

The world's local bank

HSBC

# Annual Report and Accounts 2007

## Contents



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

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

Within this document the Hong Kong Special Administrative Region of the People's Republic of China is referred to as 'Hong Kong'.

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

| | 2007 | 2006 |
|---|---|---|
| **For the year** | **HK$m** | HK$m |
| Net operating income before loan impairment charges | **127,009** | 92,325 |
| Profit before tax | **78,761** | 52,016 |
| Profit attributable to shareholders | **58,028** | 37,709 |
| **At year-end** | | |
| Shareholders' equity | **220,854** | 145,450 |
| Total equity | **245,934** | 165,445 |
| Total capital base | **206,449** | – |
| Total regulatory capital | – | 183,981 |
| Customer accounts | **2,486,106** | 1,989,467 |
| Total assets | **3,951,939** | 3,150,840 |
| **Ratios** | % | % |
| Return on average shareholders' equity | **32.1** | 31.1 |
| Post-tax return on average total assets | **1.78** | 1.46 |
| Cost efficiency ratio | **37.1** | 41.4 |
| Net interest margin | **2.37** | 2.31 |
| Capital adequacy ratios | | |
| – capital adequacy | **11.6** | – |
| – core capital | **8.8** | – |
| – total capital | – | 13.5 |
| – tier 1 capital | – | 12.3 |

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 630 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 seven other countries around the world. Employing some 59,300 people, of whom 40,700 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2007 of HK$3,952 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 83 countries and territories and assets of US$2,354 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
Telephone: (852) 2822 1111 Facsimile: (852) 2810 1112 Web: www.asiapacific.hsbc.com Telex:73201 HKBG HX

# 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*
Alexander A Flockhart, CBE, *Chief Executive Officer*
*(appointed on 25 July 2007)*
Dr Raymond Ch'ien Kuo Fung, GBS, CBE
Michael F Geoghegan, CBE
Stephen K Green
Stuart T Gulliver
Victor Li Tzar Kuoi
Dr Lo Ka Shui, GBS
Zia Mody
Raymond Or Ching Fai
Christopher D Pratt
T Brian Stevenson, SBS
Dr Patrick Wang Shui Chung
David Wei Zhe
*(appointed on 1 January 2008)*
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 24 to 172.

## Reserves

Profits attributable to shareholders, before dividends, of HK$58,028 million have been transferred to reserves. During the year, a surplus of HK$2,432 million, net of the related deferred taxation effect, arising from professional valuations of premises and held by the Bank and the group was credited to reserves. Details of the movements in reserves, including appropriations therefrom, are set out in note 40 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$1,750 million (HK$13,587 million) by the issue of 1,750 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, to finance the acquisition of a further interest in Bank of Communications Co., Ltd and to support business growth. In accordance with Hong Kong Accounting Standard 32 Financial Instruments: 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 38 and 39 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 M R P Smith and J C K So, who resigned from the Board on 15 June and 10 December 2007 respectively.

## 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, 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 share plans.

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 A A Flockhart (Chairman of the Committee), Vincent Cheng Hoi Chuen, Peter Wong Tung Shun (Directors), J W Addis (Chief Operating Officer), E D Ancona (Chief Financial Officer), R H Cox (Chief Credit Officer), C Engel (Regional Director, Personal Financial Services), P E Leech (Head of International), Margaret Leung Ko May Yee (General Manager, Global Co-Head Commercial Banking), 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$69 million.

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

The Directors are of the view that the Accounts and Supplementary Notes for the year ended 31 December 2007 fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance and the Hong Kong Monetary Authority Supervisory Policy Manual CG-1 "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, 3 March 2008

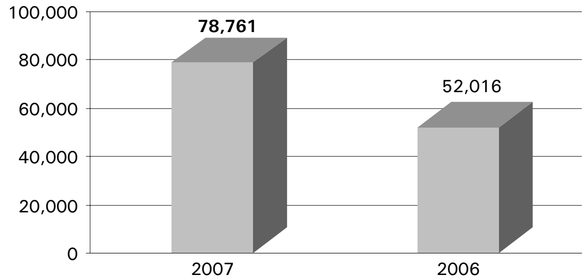
# Financial Review

## Summary of Financial Performance

### Group Profit

Profit attributable to shareholders for 2007 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiary and associated companies ('the group') increased by HK$20,319 million, or 53.9 per cent, to HK$58,028 million in 2007. Profit before taxation increased by HK$26,745 million, or 51.4 per cent, to HK$78,761 million.

**Profit before tax (HK$ millions)**



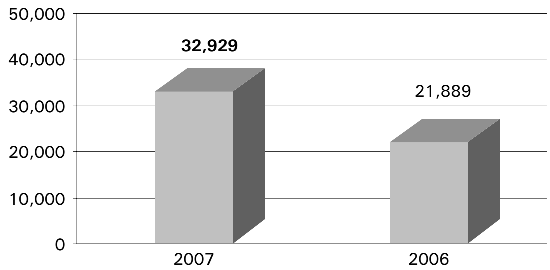

### Customer Groups

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. Global Banking and Markets (formerly known as 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 a profit before tax of HK$32,786 million, an increase of 49.8 per cent over 2006. This was driven by strong growth in operating income, partly offset by investment in continued business expansion in the rest of the Asia-Pacific region.

Personal Financial Services

**Profit before tax (HK$ millions)**




Net interest income increased by HK$5,949 million, or 19.8 per cent, compared with 2006. In Hong Kong, net interest income rose by HK$3,659 million, or 16.3 per cent, as average customer account balances grew following a series of deposit campaigns and rate offers to address customers' demand for short-term products amid the buoyant stock market and during IPO subscription periods. In addition, the relaunch of our global HSBC Premier attracted new funds, and spreads improved as a result of tactical deposit pricing and higher foreign currency interest rates. An active property market was underpinned by strong economic conditions, supported by stable domestic interest rates throughout the year. However, customer appetite for higher mortgage borrowing remained muted and intense competition led to a tightening of spreads.

In the rest of Asia-Pacific, net interest income rose by HK$2,290 million, or 29.7 per cent, driven by strong deposit growth across the region. As a result of the group's focus on growing the mass-affluent HSBC Premier customer base, deposits increased in a number of countries, particularly Singapore, mainland China and India, and deposit spreads improved on the back of higher interest rates.

Several Mainland branches were granted approval to offer certain renminbi deposit products to local residents in late 2006 and since local incorporation in March 2007, we have been gradually rolling out our renminbi services to local residents. Following regulatory inspection and confirmation, branches in eleven priority cities have commenced renminbi business to local residents. Additional branches were added in the key economic zones of the Pearl River Delta, the Yangtze River Delta and the Bohai Rim, leading to significant deposit growth. HSBC's own branded network has 18 branches and 44 sub-branches. HSBC has the largest branch network among foreign banks and remains focused on offering Premier services.

HSBC Direct was launched in South Korea in February 2007 following the launch in Taiwan in the third quarter of 2006, and both countries have progressed well, with over 240,000 customers generating deposits of more than HK$9 billion since launch. Interest earned on credit cards was higher in India, the Philippines and Thailand, reflecting growth in the number of cards in circulation and higher levels of receivables as the relationships mature. In India, HSBC has 2.6 million credit cards in circulation. Income from consumer lending also rose, notably from personal instalment loans in India and Indonesia, and spreads widened as a result of higher pricing.

Net fee income of HK$19,474 million was 85.3 per cent higher than in 2006, driven by strong business growth and favourable investment market sentiment in Hong Kong. Fee income from stockbroking and custody services rose as transaction volumes were significantly higher, reflecting buoyant stock market conditions and a large number of IPOs in Hong Kong in 2007. The retail securities volume registered over 160 per cent growth with over 80 per cent of transactions performed online. The growth rate slowed in the last few months of the year, when US sub-prime concerns and contractionary monetary policy in mainland China led to equity market falls.

Throughout 2007, sales of unit trusts and structured investment products increased significantly as investors were encouraged by informative and targeted campaigns to boost investment awareness, and by the launch of new funds, particularly those comprising China stocks. Strong investment sales were recorded in mainland China, India, South Korea and Taiwan. HSBC was granted permission to offer residents of mainland China renminbi-denominated products through its 'Qualified Domestic Institutional Investor' offerings.

Net fee income from credit cards was HK$274 million, or 20 per cent higher than in 2006. The group maintained its leadership position in Hong Kong and now has more than 4.9 million cards in circulation throughout the territory. This was augmented by a 15 per cent rise in cardholder spending as retail sales growth remained high. In the rest of Asia-Pacific, expansion of the cards business continued, particularly in India and the Philippines. The number of cards in circulation rose by 14 per cent to a total of 7.7 million, and reward programmes helped drive a 30.2 per cent increase in cardholder spending.

Income from insurance business (included within 'Net interest income', 'Net fee income', 'Net income from financial instruments designated at fair value', 'Net earned insurance premiums', the change in present value of in-force business within 'Other operating income', and after deducting 'Net insurance claims incurred and movement in policyholders' liabilities'), increased by 37 per cent, with continued focus on retirement planning services. The launch of new investment-linked insurance products contributed to growth in life assurance premium income. Sales of general insurance products also grew, supported by more efficient usage of alternative distribution channels such as the internet.

The charge for loan impairment increased by HK$242 million to HK$4,770 million, mainly due to the rapid expansion in the credit card business and changes in collection methods and regulatory restrictions on collections in India. In Hong Kong, higher loan impairment charges, mainly against credit card lending, were largely volume-driven but were partly offset by higher collective impairment releases. In the rest of Asia-Pacific, impairment charges rose in line with volume growth in cards and personal loans in India, Thailand and Australia. Delinquency rates also rose in Thailand as a result of higher minimum repayment rules for cards, coupled with a deterioration in credit conditions.

In Taiwan, impairment charges against credit card lending were lower on account of improved delinquency rates whereas prior year impairment levels were severely affected by the imposition of a mandatory government debt negotiation scheme which led to market-wide credit losses. However, conditions continue to be monitored closely in light of proposed legislation in respect of personal bankruptcy arrangements due to be introduced in

## Financial Review (continued)

Customer Groups *(continued)*

2008. In Indonesia higher recoveries were a result of improved collection efforts. The reduction in the impairment charges also benefited from greater collection efforts.

Operating expenses were HK$4,785 million, or 24 per cent, higher than in 2006, principally driven by continued investment in organic growth across the rest of the Asia-Pacific region. In Hong Kong, operating expenses rose by 15.8 per cent. Staff costs were higher primarily as a result of sales incentives and other performance-related pay, in addition to salary rises. Premises costs were higher, comprising branch refurbishments along with rises in commercial rentals. Marketing expenses rose as a result of on-going promotion of the HSBC brand and campaigns to boost business activities, particularly for wealth management products and credit cards. In the rest of Asia-Pacific, costs increased by HK$3,055 million, or 34.0 per cent, notably in India, mainland China, Indonesia and the Philippines. Headcount rose by 18.6 per cent as sales and support functions were strengthened to support business growth, premises costs rose as new outlets were opened in Indonesia, India, the Philippines, Sri Lanka, Bangladesh and mainland China. Following the launch of the consumer finance business in the region last year, India and Indonesia continued to incur investment costs to strengthen their market presence. South Korea increased staff, infrastructure and marketing expenditure related to the launch of HSBC Direct.

Income from associates of HK$506 million includes improved results from Bank of Communications and Industrial Bank.

HSBC was the recipient of four major awards from The Asian Banker this year: Best Retail Bank in Hong Kong, Best Regional Retail Business in Asia, Excellence in Bancassurance and Excellence in Internet Banking (Channel), affirming the group's leading position in personal banking in the region.

**Commercial Banking** reported profit before tax of HK$18,754 million, an increase of 25.5 per cent over 2006, driven by strong balance sheet growth.

Net interest income increased by HK$3,069 million, or 21.9 per cent, compared with 2006. This reflected growth in advances and deposits from SME customers, particularly from mainland China, resulting from product development and active marketing efforts, coupled with improvements in deposit spreads.

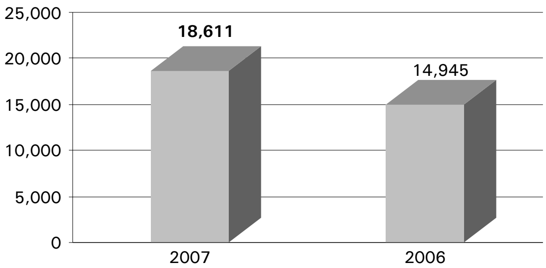
In Hong Kong, net interest income rose by HK$1,540 million, or 14.8 per cent. Stable domestic interest rates persisted through most of 2007, followed by cuts in the latter part of the year. As a result, margins were higher than in 2006, despite competitive pressures. Foreign currency deposits achieved significant growth on the back of rises in global interest rates and spreads improved as a result of active management of savings rates offered to customers. Promotional activities and continued emphasis on the SME segment contributed to the growth of 'BusinessVantage' accounts. Non-trade lending balances increased as the economy continued to grow and demand for credit remained strong. Cross-border lending to manufacturers with operations in mainland China continued to be strong as intra-Asia trade accelerated. However, asset spreads were generally tighter as a result of market competition, particularly for corporate and mid-market business customers.

In the rest of Asia-Pacific, net interest income grew by 42.8 per cent. The opening of new branches, increased commercial presence through call centres and enhancement of Business Internet Banking across the region contributed to customer acquisition. These factors helped deliver deposit and loan growth, coupled with the widening of spreads, notably in India and mainland China. Efforts were made to increase liability balances by conducting various deposit garnering campaigns in Taiwan, mainland China and Australia. Trade balances grew in South Korea, mainland China, Vietnam and India, and the business was strengthened by the acquisition of Chailease Credit Services, a Taiwanese factoring company, in May 2007. The group continued to develop its cross-border capabilities and its cross-border referral system Global Links established combined business opportunities across different geographical boundaries. Country desks were established by South Korea and Taiwan in mainland China, and a new commercial banking unit was acquired in South Africa.

## Customer Groups *(continued)*

### Commercial Banking

**Profit before tax (HK$ millions)**




Net fee income rose by HK$930 million, or 18.5 per cent, and was largely attributable to higher cash management, remittance and trade fees, particularly in Hong Kong and India, driven by increased trade flows and enhancements to customer service. Fees from sales of unit trusts and structured investment products rose as the robust Hong Kong stock market boosted investment appetite and demand for investment products. Earnings from customer foreign exchange trades also rose, reflecting an increase in cross-border payments. Remittance income was boosted by an enhanced billing system and introduction of same-day processing.

The net charge for loan impairment was HK$338 million higher than in 2006 primarily due to fewer corporate releases in Hong Kong, mainland China, Australia and Indonesia, coupled with new specific charges against a number of customers in Thailand. These increases were partly offset by a release of collective impairment provisions in Hong Kong. Credit quality generally remained stable in Hong Kong and elsewhere in the region, and there were recoveries in Mauritius and Singapore.

Operating expenses increased by 21.7 per cent over 2006, largely attributable to higher staff costs as the number of client-facing staff increased in Hong Kong, India and mainland China to support SME initiatives, insurance business expansion and product development. This included staffing of commercial-only banking branches in Hong Kong. Performance-related costs also rose significantly, in line with the improved results. The group continued to place strong emphasis in leveraging its direct channel capabilities and the number of internet-based transactions increased, contributing to efficiencies that mitigated the increased cost of processing higher volumes. There are now over 100,000 customers registered as Business Internet Banking users in Hong Kong. The Business Internet Banking site was enhanced in the first quarter, leading to processing cost efficiencies. Call centres were also re-engineered to improve their ability to promote the sale of packaged products. Direct channels constituted 47 per cent of the total number of transactions. In the rest of the Asia-Pacific region, higher costs reflected the increased sales force to support initiatives and business expansion. Higher IT and infrastructure costs and marketing expenditure were incurred in these countries and territories as a result of branch expansion.

Income from associates of HK$2,747 million includes improved results from Bank of Communications and Industrial Bank.

Commercial Banking was presented with a number of awards for its SME business including the Best SME Partner from the Hong Kong Chamber of Small and Medium Business.

**Global Banking and Markets** reported profit before tax of HK$24,804 million, 62.7 per cent higher than in 2006. Significant growth was recorded in Global Markets trading businesses and fees from securities services.

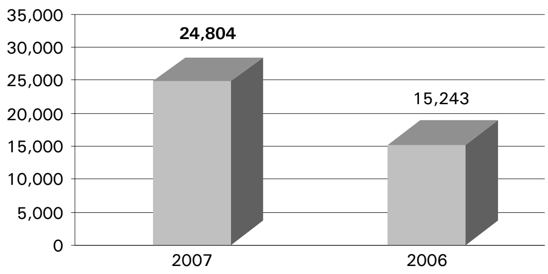
Net interest income increased by HK$6,244 million, or 68.6 per cent, compared with 2006. Balance sheet management revenues rose significantly, reflecting the replacement of maturing low-yield assets at higher yields, as well as falling US dollar interest rates in the second half of 2007, leading to lower cost of funds. Global Banking also contributed to the increase as deposit balances in payments and cash management grew on new client acquisition and organic business growth, and margin spreads improved in a number of Asian countries. This compensated for the drop in interest income from corporate lending, largely on account of margin compression in Hong Kong which was principally due to surplus liquidity in the market. Strong growth in income was recorded in India and mainland China with increased focus on emerging markets activities.

## Financial Review (continued)

### Customer Groups *(continued)*

### Global Banking and Markets

**Profit before tax (HK$ millions)**




Net fee income increased by HK$2,357 million, or 34.0 per cent compared with 2006. In Hong Kong, higher revenues in the securities and fund services business reflected increased client volumes, driven by continuing investor confidence in the local stock markets and high IPO activity. In addition, there were strong performances from South Korea, Australia, and Singapore, and capabilities in the region were strengthened by the acquisition of Westpac's sub-custody business in Australia and New Zealand last year. Investment banking benefited from strong capital markets, and underwriting revenues from IPO activities in Hong Kong grew significantly. Fee income from asset management increased by 41 per cent due to the successful launch of a number of funds, notably in China. Structured finance reported lower fees, reflecting lower transaction volumes over the same period last year.

Net trading income rose by 33.0 per cent to HK$11,547 million. Foreign exchange and interest rate derivatives profits were higher as market volatility provided good trading opportunities and higher sales volumes, particularly in Hong Kong, India and Thailand, reflecting increasing inward investment into Asia and a growing demand for risk management and investment products from customers. The equities and equity derivatives businesses in Hong Kong, which have been built up significantly over the past two years, capitalised on the strong regional stock market performances and returned excellent results. In particular, there was significant growth in structured equity derivatives, attributable to cross-sales to personal and private banking customers.

There was a net charge for loan impairment of HK$248 million compared with a net release of HK$250 million in 2006. Although the corporate credit environment throughout the region generally remained benign, there were lower releases, and a new specific allowance was made against a mainland China exposure.

Operating expenses increased by 22.3 per cent compared with 2006, reflecting headcount increases to support business expansion in all areas and higher performance-related remuneration. IT costs also rose to support business growth.

Income from associates of HK$1,244 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 the customer groups.

Gains of HK$4,735 million were made on the dilution of the group's interests in Bank of Communications, Industrial Bank and Techcombank. These three associates raised new capital during 2007, but the group did not subscribe for any additional shares issued under these offers and, as a result, its percentage shareholdings decreased. However, the assets of all three increased substantially as a result of the new issues, and consequently the group's share of the associates' underlying net assets increased by HK$4,735 million. This one-off increase was regarded as a gain arising from deemed disposals of part of the group's interests in associates, and has been recognised in the income statement.

These gains were slightly offset by lower gains from financial investments as 2006 included profit on the disposal of part of the group's stake in UTI Bank. In addition, there were lower profits made on property sales in 2007 compared with 2006.

Customer Groups *(continued)*

**(HK$ millions)**

| | Personal Financial Services | Commercial Banking | Global Banking and Markets | Private Banking | Other | Intra-segment elimination | Total |
|---|---|---|---|---|---|---|---|
| **2007** | | | | | | | |
| Net interest income/(expense) | **36,039** | **17,075** | **15,348** | **47** | **(4,536)** | **(1,212)** | **62,761** |
| Net fee income/(expense) | **19,474** | **5,948** | **9,294** | **105** | **120** | **–** | **34,941** |
| Net trading income | **1,761** | **1,033** | **11,547** | **62** | **950** | **703** | **16,056** |
| Net income/(loss) from financial instruments designated at fair value | **6,966** | **(72)** | **31** | **–** | **(1,233)** | **509** | **6,201** |
| Gains less losses from financial investments | **23** | **1** | **427** | **–** | **441** | **–** | **892** |
| Gains arising from dilution of investments in associates | **–** | **–** | **–** | **–** | **4,735** | **–** | **4,735** |
| Dividend income | **16** | **6** | **134** | **–** | **537** | **–** | **693** |
| Net earned insurance premiums | **22,363** | **1,200** | **132** | **–** | **–** | **–** | **23,695** |
| Other operating income | **1,323** | **249** | **714** | **20** | **7,137** | **(5,387)** | **4,056** |
| Total operating income | **87,965** | **25,440** | **37,627** | **234** | **8,151** | **(5,387)** | **154,030** |
| Net insurance claims incurred and movement in policyholders' liabilities | **(26,217)** | **(703)** | **(101)** | **–** | **–** | **–** | **(27,021)** |
| Net operating income before loan impairment charges and other credit risk provisions | **61,748** | **24,737** | **37,526** | **234** | **8,151** | **(5,387)** | **127,009** |
| Loan impairment charges and other credit risk provisions | **(4,770)** | **(784)** | **(248)** | **–** | **(3)** | **–** | **(5,805)** |
| Net operating income | **56,978** | **23,953** | **37,278** | **234** | **8,148** | **(5,387)** | **121,204** |
| Operating expenses | **(24,698)** | **(7,946)** | **(13,718)** | **(241)** | **(5,962)** | **5,387** | **(47,178)** |
| Operating profit/(loss) | **32,280** | **16,007** | **23,560** | **(7)** | **2,186** | **–** | **74,026** |
| Share of profit in associates and joint venture | **506** | **2,747** | **1,244** | **–** | **238** | **–** | **4,735** |
| Profit/(loss) before tax | **32,786** | **18,754** | **24,804** | **(7)** | **2,424** | **–** | **78,761** |

# Financial Review (continued)

Customer Groups *(continued)*

**(HK$ millions)**

| | Personal Financial Services | Commercial Banking | Global 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 | 10,512 | 5,018 | 6,937 | 101 | (164) | – | 22,404 |
| Net trading income/(loss) | 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 Interest Income

**Net interest income** of HK$62,761 million was HK$11,662 million, or 22.8 per cent, higher than in 2006. Higher income was attributable to strong balance sheet growth and improved deposit spreads throughout the region, coupled with higher balance sheet management income.

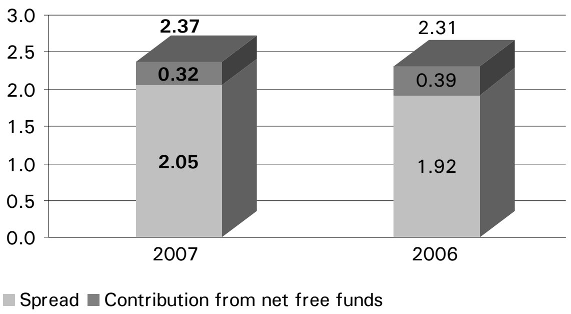
Net interest income in Personal Financial Services rose by HK$5,949 million, or 19.8 per cent, partly due to strong growth in the deposit base in Hong Kong and in the region. Lending growth also contributed to the increase in interest income, particularly personal instalment loans in India, South Korea, Thailand and at Hang Seng Bank, and credit cards in the Philippines, India, Singapore, Australia and at Hang Seng Bank. In addition, strong returns were 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$3,069 million, or 21.9 per cent higher than in 2006, mainly due to balance sheet growth, notably in Hong Kong, India and mainland China, and the widening of deposit spreads. In Global Banking and Markets, net interest income increased significantly as a result of strong balance sheet management income, reflecting the replacement of maturing assets at higher yields. This was coupled with business growth in the payments and cash management and securities services businesses and improved deposits spreads, notably in mainland China, India, Hong Kong and Taiwan.

**Average interest-earning assets** rose by HK$436.6 billion, or 19.7 per cent, to HK$2,649.1 billion. Average advances to customers grew by HK$95.4 billion, or 9.1 per cent, with strong increases in corporate loans in India, mainland China and at Hang Seng Bank, and a small rise in average mortgage balances in Hong Kong, coupled with stronger growth in India and Singapore. These were partly offset by the disposal of the broker-originated mortgage businesses in Australia. Average credit card balances rose in most areas, notably Hong Kong, India, Australia, the Philippines, Thailand and Singapore, and personal instalment loans grew, most significantly in India, South Korea and Thailand. Average placements with banks were HK$174.3 billion higher, and holdings of available-for-sale securities rose by HK$85.8 billion, reflecting the deployment of the commercial surplus.

| (HK$ millions) | 2007 | 2006 |
|---|---|---|
| Average interest-earning assets | **2,649,116** | 2,212,521 |

The group's **net interest margin** of 2.37 per cent for 2007 was six basis points higher than in 2006. Net interest spread improved by 13 basis points, while the contribution from net free funds declined by seven basis points, reflecting the deployment of funds into trading assets.

**Net interest margin (%)**




For the bank in Hong Kong, net interest margin increased by one basis point to 2.27 per cent. Spread rose by 11 basis points, benefiting from higher yields on money market placements, debt securities and term lending, and improved deposit spreads in current and savings accounts, but was partly offset by lower spread on mortgages as the Hong Kong dollar Best Lending Rate decreased. The contribution from net free funds decreased by 10 basis points, primarily due to the reduction of free funds as a result of redeployment of surplus funds into trading assets.

At Hang Seng Bank, net interest margin improved by 12 basis points to 2.54 per cent, benefiting from wider deposit spreads and better yields on the balance sheet management portfolio. Balance sheet management income improved as lower yielding securities gradually matured and were replaced by higher yielding assets. Net interest spread rose by 15 basis points to 1.98 per cent, whilst the contribution from net free funds decreased by three basis points. Higher net interest spread was attributable to the increase of average customer deposits, mainly in lower cost savings balances, and wider deposit spreads. However, the pricing of residential mortgages and corporate lending remained under pressure due to intense market competition.

**Net interest margin (%)**

| | 2007 | 2006 |
|---|---|---|
| Hong Kong: | | |
| The bank | **2.27** | 2.26 |
| Hang Seng Bank | **2.54** | 2.42 |
| Rest of Asia-Pacific | **2.25** | 2.16 |

In the rest of Asia-Pacific, net interest margin at 2.25 per cent was nine basis points higher than in 2006, and spread increased by 12 basis points to 2.06 per cent. In mainland China, spread improved as the increase in lending rates outweighed the rise in deposit rates, supported by an increase in low cost customer deposits. Spread improved in Indonesia as funding costs decreased following interest rate cuts. In the Philippines, local interest rates dropped but strong growth in high yielding credit card receivables more than offset the decline in yields for other lending products. Taiwan benefited from improved spreads on customer accounts, whereas Singapore saw higher spreads on mortgages and cards as funding costs decreased. The contribution from net free funds dropped by three basis points mainly due to an increase in the redeployment of funding to trading assets in Australia, South Korea and mainland China, which was partly offset by a rise in both market interest rates and non-interest bearing account balances in India.

# Financial Review (continued)

## Net Fee Income

**Net fee income** was HK$12,537 million, or 56.0 per cent, higher than 2006.

Securities broking and custody fees rose by 125 per cent, reflecting significantly higher stock market turnover in Hong Kong. The buoyant stock markets also stimulated demand for unit trusts and investment funds in Hong Kong, India and Korea and fee income increased by 80.1 per cent.

Trade finance income was 13.7 per cent higher, notably in India, Hong Kong, Singapore and mainland China, and in part due to the transfer into the group of HSBC's South African operations in the second quarter of 2007. Remittance and other account fees grew, reflecting the group's strong transactional capabilities.

Card fees were in line with 2006, with the disposal of the card acquiring business and a decline in card fees in Taiwan as a result of the 2006 credit crisis largely offset by strong growth in issuing fees elsewhere in the region, notably India, Hong Kong and the Philippines, due to an increase in the number of cards in circulation and higher cardholder spending.

'Other' includes investment banking fees which were higher as several IPO mandates in Hong Kong were won, and an increase in commissions received from fellow HSBC Group companies in respect of treasury business.

| (HK$ millions) | 2007 | 2006 |
|---|---|---|
| Account services | **1,625** | 1,501 |
| Credit facilities | **1,471** | 1,245 |
| Import/export | **3,360** | 2,956 |
| Remittances | **1,653** | 1,437 |
| Securities/stockbroking | **11,874** | 5,267 |
| Cards | **4,321** | 4,335 |
| Insurance | **889** | 315 |
| Unit trusts | **4,714** | 2,326 |
| Funds under management | **3,833** | 2,974 |
| Other | **7,409** | 4,198 |
| Fee income | **41,149** | 26,554 |
| Fee expense | **(6,208)** | (4,150) |
| Net fee income | **34,941** | 22,404 |

## Net Trading Income

Trading income rose by 80 per cent to HK$16,056 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 previous investment in business expansion and buoyant stock markets.

| (HK$ millions) | 2007 | 2006 |
|---|---|---|
| Dealing profits | **12,832** | 10,001 |
| Gain from hedging activities | **63** | 16 |
| Net interest income/(expense) | **2,677** | (1,307) |
| Dividend income from trading securities | **484** | 208 |
| Net trading income | **16,056** | 8,918 |

## Gains Less Losses from Financial Investments

The profit on the disposal of available-for-sale securities in 2007 largely comprises gains on the sale of equity shares and further disposals of Philippine government securities. Prior year gains include the profits made on the sale of part of the group's stake in UTI Bank in India, and also on Philippine government securities.

| (HK$ millions) | 2007 | 2006 |
|---|---|---|
| Profit on disposal of available-for-sale securities | **892** | 1,466 |

## Other Operating Income

Profit on the disposal of property, plant and equipment was lower than in 2006 due to the non-recurrence of gains made on the sale of a property in Japan and lower gains from disposal of Hang Seng Bank properties.

Profit on disposal of subsidiaries, associates and business portfolios was lower than 2006 due to the non-recurrence of gains made on the disposal of the stockbroking, margin lending and broker originated mortgage businesses in Australia.

'Other' mainly comprises recoveries of IT and other operating costs from fellow HSBC Group companies which were incurred on their behalf.

| (HK$ millions) | 2007 | 2006 |
|---|---|---|
| Rental income from investment properties | **151** | 196 |
| Movement in present value of in-force insurance business | **950** | 1,124 |
| Gains on investment properties | **564** | 475 |
| Profit on disposal of property, plant and equipment, and assets held for sale | **63** | 981 |
| Profit on disposal of subsidiaries, associates and business portfolios | **96** | 904 |
| Surplus arising on property revaluation | **122** | 70 |
| Other | **2,110** | 1,903 |
| Other operating income | **4,056** | 5,653 |

## Financial Review (continued)

### Loan Impairment Charges and Other Credit Risk Provisions

The net charge for loan impairment and other credit risk provisions was HK$996 million higher than in 2006.

The charge for new individually assessed allowances was higher, largely attributable to the downgrading of certain corporate customers with activities in Thailand, Hang Seng Bank, India and Sri Lanka. The increase was partly offset by lower corporate charges in Singapore, mainland China, and Japan. Releases and recoveries were lower, mainly relating to companies in Hong Kong, mainland China, Australia and Indonesia.

The net charge for collectively assessed allowances increased. Charges increased in India, Hong Kong and Thailand, reflecting higher credit card and other personal lending volumes.

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

| | **2007** | 2006 |
|---|---|---|
| Hong Kong | **1,654** | 1,228 |
| Rest of Asia-Pacific | **4,006** | 3,473 |
| Americas/Europe | **–** | – |
| Total | **5,660** | 4,701 |

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

| | **2007** | 2006 |
|---|---|---|
| Net charge for impairment of customer advances | | |
| – Individually assessed impairment allowances: | | |
| New allowances | **1,884** | 1,314 |
| Releases | **(646)** | (869) |
| Recoveries | **(197)** | (212) |
| | **1,041** | 233 |
| – Net charge for collectively assessed impairment allowances | **4,619** | 4,468 |
| | **5,660** | 4,701 |
| Net charge of other credit risk provisions | **145** | 108 |
| Net charge for loan impairment and other credit risk provisions | **5,805** | 4,809 |

### Operating Expenses

Staff costs increased by HK$5,389 million, or 25.6 per cent, compared with 2006. Wages and salaries rose by 16.7 per cent, in line with planned increases in headcount throughout the region, and due to annual salary rises notably in Hong Kong, mainland China, India, Singapore and South Korea. Staff numbers rose significantly in India reflecting the establishment of the consumer finance business and expansion of the sales force, and in mainland China to support new branch openings. Performance-related pay increased in line with improved operating revenues, higher dealing income and the increase in headcount.

## Operating Expenses *(continued)*

**Staff numbers by region***

| | 2007 | 2006 |
|---|---|---|
| Hong Kong: | | |
| The bank and wholly owned subsidiaries | **16,979** | 18,032 |
| Hang Seng Bank | **9,190** | 8,464 |
| Total Hong Kong | **26,169** | 26,496 |
| | | |
| Rest of Asia-Pacific: | | |
| Australia | **1,458** | 1,355 |
| Mainland China | **6,356** | 3,732 |
| India | **7,243** | 6,064 |
| Indonesia | **2,590** | 2,744 |
| Singapore | **2,473** | 2,312 |
| Taiwan | **2,144** | 2,392 |
| Sri Lanka | **1,843** | 1,537 |
| Others | **9,078** | 8,919 |
| Total rest of Asia-Pacific | **33,167** | 27,518 |
| Americas/Europe | **18** | 17 |
| Total | **59,354** | 54,031 |

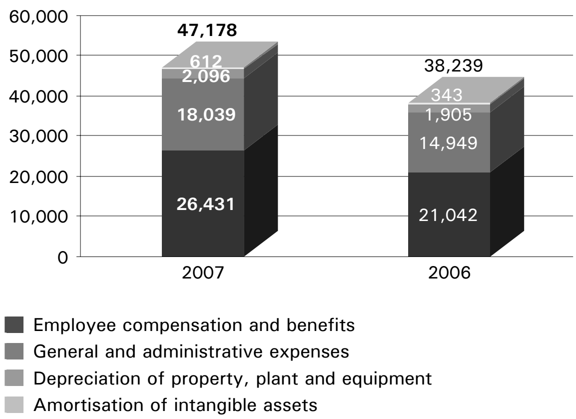
* *Full time equivalent*

The increase in general and administrative expenses of HK$3,090 million, or 20.7 per cent, reflected additional costs incurred in business expansion throughout the region. Premises and equipment costs rose due to new branch openings and rent increases.

Marketing expenditure was higher with higher credit card bonus point redemption costs in Hong Kong, brand advertising at airports in mainland China, and retail banking promotions at Hang Seng Bank. Technology costs also increased as the group continued to improve its customer relationship management systems and internet banking capabilities.

| | 2007 | 2006 |
|---|---|---|
| Cost efficiency ratio (%) | **37.1** | 41.4 |

**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 amortisation of intangible assets arising on acquisition.

| (HK$ millions) | 2007 | 2006 |
|---|---|---|
| Share of profit in associates and joint venture | **4,735** | 2,739 |

## Tax Expense

The effective rate of tax for 2007 was 17.1 per cent compared with 18.1 per cent in 2006. The decrease was mainly as a result of the HK$4,735 million of dilution gains recognised in the year being non taxable.

| | 2007 | 2006 |
|---|---|---|
| Effective rate of tax (%) | **17.1** | 18.1 |

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## Financial Review (continued)

### Assets

Total assets increased by HK$801 billion, or 25.4 per cent, since 31 December 2006.

Cash and short-term funds increased by HK$277 billion, or 53.5 per cent, the most notable increase being in Hang Seng bank due to deposit growth. Placings with banks maturing after one month decreased by HK$44 billion, or 42.1 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$22 billion, or 6.5 per cent. The holding of Treasury bills reduced however, this was offset by a 208 per cent increase in holdings of loans and advances to banks mainly for stock borrowing activities.

Net advances to customers increased by HK$168 billion, or 16.1 per cent, since the end of 2006.

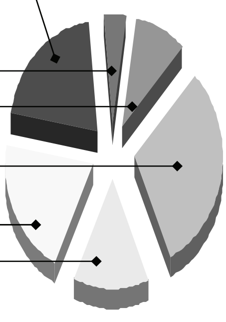
Net advances in Hong Kong rose by HK$34 billion, or 5.1 per cent. Mortgage lending increased by 3.2 per cent due to successful campaigns by the bank in Hong Kong and Hang Seng Bank. This excludes the impact of the fall in lending under the Government Home Ownership Scheme which remained suspended throughout 2007. Credit card and other personal lending rose by 20.0 per cent following extensive marketing activity. Corporate and commercial loan balances increased by 3.3 per cent boosted by increased demand from manufacturers with operations in mainland China.

In the rest of Asia-Pacific, net advances increased by HK$134.4 billion, or 32.6 per cent. Mortgage lending increased by 13.9 per cent, principally in mainland China where balances grew 173.4 per cent. Credit card receivables grew by 29.6 per cent, largely in India, Australia, the Philippines and Thailand, offset in part by a fall in Taiwan. Lending to commercial and corporate customers rose by 45.5 per cent, notably in mainland China, India, Singapore and Australia, as the group focused on capturing cross-border business and the provision of trade finance.

Financial investments rose by HK$47.4 billion, or 9.8 per cent. In Hong Kong balances decreased by HK$15.8 billion. The notable increases were in Singapore, India and mainland China and were a result of increases in liquidity ratio requirements.

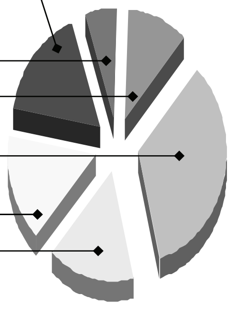
**Assets 2007***

| | % | HK$ millions |
|---|---|---|
| Cash and short-term funds | **20.7** | **794,923** |
| Placings with banks maturing after one month and certificates of deposit | **4.1** | **156,686** |
| Trading assets | **9.4** | **360,704** |
| Advances to customers | **31.5** | **1,212,086** |
| Financial investments | **13.8** | **532,243** |
| Other | **20.5** | **786,753** |
| Total | **100.0** | **3,843,595** |



**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 |



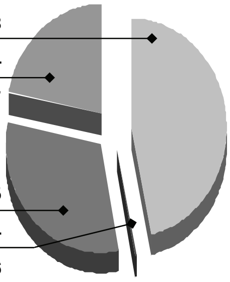
* *Excluding Hong Kong SAR Government certificates of indebtedness*

## Customer Accounts

Customer accounts increased by HK$497 billion, or 25.0 per cent since the end of 2006. This excludes structured deposits, which decreased by HK$12.9 billion, as these are included with 'Trading liabilities'.

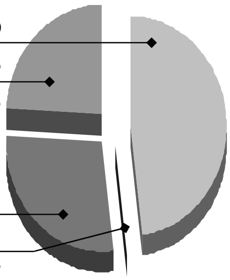
**Customer accounts 2007**

| | % | HK$ millions |
|---|---|---|
| Hong Kong excluding Hang Seng Bank | **46.8** | **1,161,823** |
| Hang Seng Bank | **21.9** | **544,724** |
| Total Hong Kong | **68.7** | **1,706,547** |
| Rest of Asia-Pacific | **31.2** | **776,505** |
| Americas/Europe | **0.1** | **3,054** |
| Total | **100.0** | **2,486,106** |



**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 |



In Hong Kong, customer accounts rose by HK$270 billion, or 18.8 per cent, largely in savings and other account balances, driven by a series of tactical campaigns and new deposit initiatives, including 'Deposits SmartPicks', which led to new customer acquisition. Deposits from personal customers increased by HK$91 billion, or 10.0 per cent, as a result. Growth in the number of Premier customers was particularly marked in the second half of 2007 following the global relaunch in May, which emphasised the benefits of international banking connectivity and enhanced service benefits. In Commercial Banking and Global Banking and Markets, customer account balances grew by HK$185.9 billion, or 36.2 per cent. A focus on straight-through processing and simplified account opening procedures attracted customers as the convenience of the internet and other direct options provided them with more flexible options for their business operations.

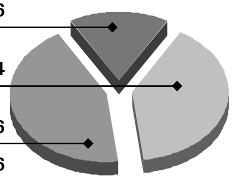
In the rest of Asia-Pacific, customer accounts increased by HK$225.8 billion, or 41.0 per cent, largely in current accounts and other accounts as the group actively sought to grow the deposit base throughout the region. Deposits from personal customers grew by HK$50.5 billion, or 25.0 per cent, notably in India, Australia and mainland China. Customer account balances held by corporate customers in Commercial Banking and Global Banking and Markets rose by HK$163.4 billion, or 47.7 per cent, largely in mainland China, India, Singapore and Korea.

The group's advances-to-deposits ratio fell to 48.8 per cent at 31 December 2007 from 52.5 per cent at 31 December 2006.

| | **2007** | 2006 |
|---|---|---|
| Advances: deposits ratio (%) | **48.8** | 52.5 |

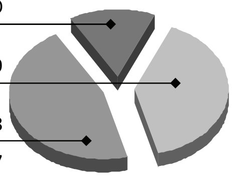
**Customer accounts 2007**

| | % | HK$ millions |
|---|---|---|
| Current accounts | **16.8** | **417,786** |
| Savings accounts | **39.5** | **983,874** |
| Other deposit accounts | **43.7** | **1,084,446** |
| Total | **100.0** | **2,486,106** |



**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 |



## Financial Review (continued)

Equity

Equity increased by HK$81 billion, or 48.7 per cent, to HK$246 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 investments in Ping An Insurance and the Bank of Shanghai.

### Capital Adequacy

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

With the Banking (Capital) Rules ('the Capital Rules') effective on 1 January 2007, the Hongkong and Shanghai Banking Corporation Limited uses the standardised (credit risk) approach and standardised (securitisation) approach to calculate its credit risk for non-securitisation exposures and credit risk for securitisation exposures respectively. It also uses standardised (operational risk) approach and standardised (market risk) approach to calculate its operational risk and market risk respectively. However, an internal model approach is adopted for calculating the general market risk and a separate model is used for calculating the market risk relating to equity options. This basis is different to the basis used at 31 December 2006, and the numbers are therefore not strictly comparable.

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

Figures in HK$m

| **At 31 December 2007** | |
|---|---|
| **Composition of capital** | |
| **Core Capital:** | |
| Paid-up ordinary share capital | 21,040 |
| Paid-up irredeemable non-cumulative preference shares | 51,882 |
| Published reserves | 72,069 |
| Profit and loss account | 29,543 |
| Minority interests**** | 21,318 |
| Less: Deduction from core capital | (11,111) |
| Less: 50% of total amount of deductible items (@50%)***** | (28,894) |
| **Total core capital** | **155,847** |
| | |
| **Supplementary Capital:** | |
| Property revaluation reserves* | 5,869 |
| Available-for-sale investments revaluation reserves** | 4,434 |
| Unrealised fair value gains from financial instruments designated at fair value through profit or loss | 137 |
| Regulatory reserve*** | 4,148 |
| Collective provisions | 5,078 |
| Perpetual subordinated debt | 9,415 |
| Paid-up irredeemable cumulative preference shares | 16,610 |
| Term subordinated debt | 11,970 |
| Paid-up term preference shares | 21,835 |
| Less: 50% of total amount of deductible items (@ 50%)***** | (28,894) |
| **Total supplementary capital** | **50,602** |
| **Capital base** | **206,449** |
| **Total deductible items******* | **57,788** |

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

| **At 31 December 2007** | |
|---|---|
| Capital adequacy ratio | 11.6% |
| Core capital ratio | 8.8% |

* *Includes the revaluation surplus on investment properties which is reported as part of retained profits.*

** *Includes adjustments made in accordance with guidelines issued by the HKMA.*

*** *The regulatory reserve is maintained for the purpose of satisfying the Banking Ordinance for prudential supervision.*

**** *After deduction of minority interests in unconsolidated subsidiary companies.*

***** *Total deductible items are deducted from institution's core capital and supplementary capital.*

**Capital Adequacy** *(continued)*

The following table sets out an analysis of regulatory capital and capital adequacy ratios for the group. They are calculated in accordance with the Third Schedule of the Hong Kong Banking Ordinance.

This basis is different from the basis used at 31 December 2007, and the numbers are therefore not strictly comparable.

Figures in HK$m

| **At 31 December 2006** | |
|---|---|
| **Composition of capital** | |
| **Tier 1:** | |
| Total shareholders' equity | 145,450 |
| Less: proposed dividend | (6,500) |
| property revaluation reserves* | (7,892) |
| available-for-sale investment reserves** | (26,028) |
| classified as regulatory reserve*** | (1,689) |
| goodwill | (4,182) |
| others | (138) |
| Irredeemable non-cumulative preference shares | 51,735 |
| Minority interests**** | 17,483 |
| **Total qualifying tier 1 capital** | 168,239 |
| | |
| **Tier 2:** | |
| Property revaluation reserves (@ 70%) | 5,524 |
| Available-for-sale investment reserves (@ 70%) | 18,220 |
| Collective impairment provision and regulatory reserve | 6,610 |
| Perpetual subordinated debt | 9,370 |
| Term subordinated debt | 9,849 |
| Term preference shares | 8,165 |
| Irredeemable cumulative preference shares | 16,563 |
| Total qualifying tier 2 capital | 74,301 |
| Deductions | (58,559) |
| **Total capital** | 183,981 |
| **Risk weighted assets** | 1,367,607 |

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

| **As 31 December 2006** | |
|---|---|
| Total capital | 13.5% |
| Tier 1 capital | 12.3% |

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 risks, are as follows:

| **As 31 December 2006** | |
|---|---|
| Total capital | 13.0% |
| Tier 1 capital | 11.8% |

* *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 the 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 accounts of subsidiary companies.*

## Financial Review (continued)

### Non-bank Mainland exposures

The analysis on non-bank Mainland exposures is based on the categories of non-bank counterparties and the type of direct exposures defined by the HKMA under the Banking (Disclosure) Rules with reference to the HKMA return for non-bank Mainland exposures, which includes the mainland exposures extended by the Bank and its banking subsidiary in mainland China as at 31 December 2007 and the Bank as at 31 December 2006.

In April 2007, HSBC Bank (China) Company Limited ('HBCN'), the Bank's wholly owned subsidiary incorporated in mainland China, was established to take over the majority of the assets and liabilities of the Bank's mainland branches. The mainland exposures of HBCN are shown separately in the HKMA return as at 31 December 2007.

**At 31 December 2007**

| | **On-balance sheet exposure** | **Off-balance sheet exposure** | **Total exposures** | **Specific provisions** |
|---|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| Mainland entities | **13,833** | **18,212** | **32,045** | **53** |
| Companies and individuals outside the Mainland where the credit is granted for use in Mainland | **36,598** | **39,475** | **76,073** | **83** |
| Other counterparties the exposures to whom are considered by the bank to be non-bank Mainland exposures | **769** | **2,565** | **3,334** | **–** |
| | **51,200** | **60,252** | **111,452** | **136** |
| Mainland exposures of HBCN | **64,632** | **13,083** | **77,715** | **56** |
| | **115,832** | **73,335** | **189,167** | **192** |

**At 31 December 2006**

| | On-balance sheet exposure | Off-balance sheet exposure | Total exposures | Specific provisions |
|---|---|---|---|---|
| | HK$m | HK$m | HK$m | HK$m |
| Mainland entities | 51,101 | 35,180 | 86,281 | 173 |
| Companies and individuals outside the Mainland where the credit is granted for use in Mainland | 37,992 | 35,556 | 73,548 | 49 |
| Other counterparties the exposures to whom are considered by the bank to be non-bank Mainland exposures | 295 | 1,782 | 2,077 | – |
| | 89,388 | 72,518 | 161,906 | 222 |

## 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 2007**

| | Banks and Other Financial Institutions | Public Sector Entities | Other | Total |
|---|---|---|---|---|
| **(HK$ millions)** | | | | |
| **Americas** | | | | |
| United States | **53,963** | **63,624** | **62,638** | **180,225** |
| Other | **48,643** | **2,713** | **51,189** | **102,545** |
| | **102,606** | **66,337** | **113,827** | **282,770** |
| **Europe** | | | | |
| United Kingdom | **322,972** | **17** | **46,218** | **369,207** |
| Other | **450,375** | **1,651** | **48,113** | **500,139** |
| | **773,347** | **1,668** | **94,331** | **869,346** |
| **Asia-Pacific excluding Hong Kong** | **241,481** | **104,092** | **171,184** | **516,757** |

**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 |

# Financial Review (continued)

## Risk Management

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

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

Credit risk, liquidity risk, market risk and insurance risk are discussed in detail in Note 52 on the Accounts on pages 153 to 170.

### Market Risk Management

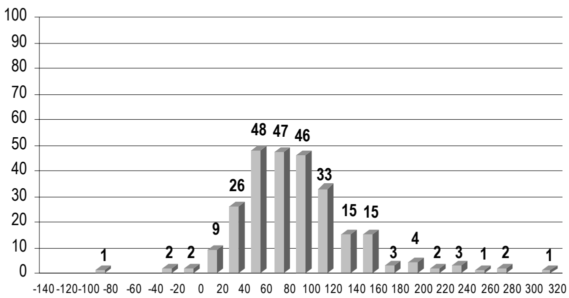
The nature of market risk and the principal tool used to monitor and limit market risk exposure (value at risk) are discussed in Note 52 on the Accounts on pages 162 to 166.

The average daily revenue earned from market risk-related treasury activities in 2007, including accrual book net interest income and funding related to dealing positions, was HK$84 million compared with HK$46 million in 2006. The standard deviation of these daily revenues was HK$52 million (HK$23 million for 2006).

An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on five days in 2007. The most frequent result was a daily revenue of between HK$40 million and HK$60 million with 48 occurrences. The highest daily revenue was HK$305 million. In 2006, the negative revenues did not occur on any day. The most frequent result in 2006 was a daily revenue of between HK$40 million and HK$60 million with 90 occurrences. The highest daily revenue in 2006 was HK$127 million.

**Daily distribution of market risk revenues 2007**

Number of days

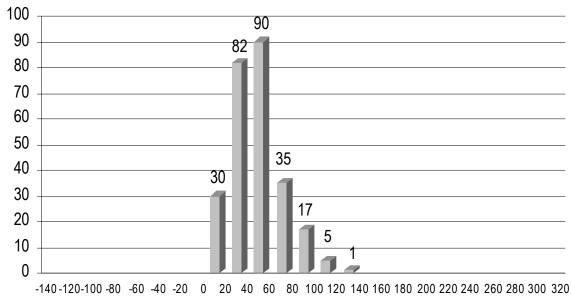



Revenues *(HK$ millions)*

Profit and loss frequency

**Daily distribution of market risk revenues 2006**

Number of days




Revenues *(HK$ millions)*

Profit and loss frequency

## 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 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 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 2007

| | Note | **2007 HK$m** | 2006 HK$m |
|---|---|---|---|
| Interest income | *5a* | **144,153** | 115,928 |
| Interest expense | *5b* | **(81,392)** | (64,829) |
| Net interest income | | **62,761** | 51,099 |
| Fee income | | **41,149** | 26,554 |
| Fee expense | | **(6,208)** | (4,150) |
| Net fee income | *5c* | **34,941** | 22,404 |
| Net trading income | *5d* | **16,056** | 8,918 |
| Net income from financial instruments designated at fair value | *5e* | **6,201** | 2,670 |
| Gains less losses from financial investments | *5f* | **892** | 1,466 |
| Gains less losses from dilution of investments in associates | *5g* | **4,735** | – |
| Dividend income | *5h* | **693** | 749 |
| Net earned insurance premiums | *5i* | **23,695** | 21,846 |
| Other operating income | *5j* | **4,056** | 5,653 |
| **Total operating income** | | **154,030** | 114,805 |
| Net insurance claims incurred and movement in policyholders' liabilities | *5k* | **(27,021)** | (22,480) |
| **Net operating income before loan impairment charges and other credit risk provisions** | | **127,009** | 92,325 |
| Loan impairment charges and other credit risk provisions | *5l* | **(5,805)** | (4,809) |
| **Net operating income** | | **121,204** | 87,516 |
| Employee compensation and benefits | *5m* | **(26,431)** | (21,042) |
| General and administrative expenses | *5n* | **(18,039)** | (14,949) |
| Depreciation of property, plant and equipment | | **(2,096)** | (1,905) |
| Amortisation of intangible assets | *24c* | **(612)** | (343) |
| **Total operating expenses** | | **(47,178)** | (38,239) |
| **Operating profit** | | **74,026** | 49,277 |
| Share of profit in associates and joint ventures | | **4,735** | 2,739 |
| **Profit before tax** | | **78,761** | 52,016 |
| Tax expense | *6* | **(13,456)** | (9,411) |
| **Profit for the year** | | **65,305** | 42,605 |
| | | | |
| Profit attributable to shareholders | | **58,028** | 37,709 |
| Profit attributable to minority interests | | **7,277** | 4,896 |

# Consolidated Balance Sheet at 31 December 2007

| | Note | **2007 HK$m** | 2006 HK$m |
|---|---|---|---|
| **ASSETS** | | | |
| Cash and short-term funds | *10* | **794,923** | 518,022 |
| Items in the course of collection from other banks | | **20,357** | 46,519 |
| Placings with banks maturing after one month | *11* | **60,328** | 104,037 |
| Certificates of deposit | *12* | **97,358** | 73,200 |
| Hong Kong SAR Government certificates of indebtedness | *13* | **108,344** | 102,374 |
| Trading assets | *14* | **360,704** | 338,792 |
| Financial assets designated at fair value | *15* | **63,152** | 50,514 |
| Derivatives | *16* | **180,440** | 99,167 |
| Advances to customers | *17* | **1,212,086** | 1,043,782 |
| Financial investments | *20* | **532,243** | 484,841 |
| Amounts due from Group companies | | **364,724** | 161,118 |
| Investments in associates and joint ventures | *23* | **39,832** | 25,534 |
| Goodwill and intangible assets | *24* | **12,309** | 10,428 |
| Property, plant and equipment | *25* | **33,356** | 29,159 |
| Deferred tax assets | *35* | **1,566** | 1,245 |
| Retirement benefit assets | *5m* | **123** | 2,191 |
| Other assets | *27* | **70,094** | 59,917 |
| **Total assets** | | **3,951,939** | 3,150,840 |
| **LIABILITIES** | | | |
| Hong Kong SAR currency notes in circulation | *13* | **108,344** | 102,374 |
| Items in the course of transmission to other banks | | **31,586** | 57,226 |
| Deposits by banks | *28* | **169,177** | 108,125 |
| Customer accounts | *29* | **2,486,106** | 1,989,467 |
| Trading liabilities | *30* | **265,675** | 272,545 |
| Financial liabilities designated at fair value | *31* | **38,147** | 36,554 |
| Derivatives | *16* | **173,322** | 98,659 |
| Debt securities in issue | *32* | **84,523** | 69,195 |
| Retirement benefit liabilities | *5m* | **1,537** | 465 |
| Amounts due to Group companies | | **65,846** | 31,356 |
| Other liabilities and provisions | *33* | **70,203** | 56,478 |
| Liabilities under insurance contracts issued | *34* | **91,730** | 61,350 |
| Current tax liabilities | *6* | **5,833** | 4,500 |
| Deferred tax liabilities | *35* | **5,148** | 4,284 |
| Subordinated liabilities | *37* | **18,500** | 16,353 |
| Preference shares | *38* | **90,328** | 76,464 |
| **Total liabilities** | | **3,706,005** | 2,985,395 |
| **EQUITY** | | | |
| Share capital | *39* | **22,494** | 22,494 |
| Other reserves | *40* | **83,952** | 35,514 |
| Retained profits | *40* | **107,908** | 80,942 |
| Proposed fourth interim dividend | *8* | **6,500** | 6,500 |
| Total shareholders' equity | | **220,854** | 145,450 |
| Minority interests | *40* | **25,080** | 19,995 |
| Total equity | | **245,934** | 165,445 |
| **Total equity and liabilities** | | **3,951,939** | 3,150,840 |

*Directors*
Vincent H C Cheng
Alexander A Flockhart
Peter T S Wong

*Secretary*
M W Scales

# Balance Sheet at 31 December 2007

| | Note | 2007 HK$m | 2006 HK$m |
|---|---|---|---|
| **ASSETS** | | | |
| Cash and short-term funds | *10* | **637,771** | 426,176 |
| Items in the course of collection from other banks | | **13,946** | 40,434 |
| Placings with banks maturing after one month | *11* | **39,842** | 79,249 |
| Certificates of deposit | *12* | **48,788** | 33,907 |
| Hong Kong SAR Government certificates of indebtedness | *13* | **108,344** | 102,374 |
| Trading assets | *14* | **260,107** | 284,057 |
| Financial assets designated at fair value | *15* | **2,861** | 11,182 |
| Derivatives | *16* | **178,184** | 97,834 |
| Advances to customers | *17* | **743,530** | 686,468 |
| Financial investments | *20* | **254,225** | 243,223 |
| Amounts due from group companies | | **381,236** | 169,117 |
| Investments in subsidiary companies | *22* | **16,374** | 7,828 |
| Investments in associates and joint ventures | *23* | **20,461** | 17,508 |
| Goodwill and intangible assets | *24* | **4,027** | 3,360 |
| Property, plant and equipment | *25* | **19,295** | 16,635 |
| Deferred tax assets | *35* | **977** | 753 |
| Retirement benefit assets | *5m* | **51** | 1,273 |
| Other assets | *27* | **49,617** | 46,652 |
| **Total assets** | | **2,779,636** | 2,268,030 |
| **LIABILITIES** | | | |
| Hong Kong SAR currency notes in circulation | *13* | **108,344** | 102,374 |
| Items in the course of transmission to other banks | | **22,837** | 50,618 |
| Deposits by banks | *28* | **126,604** | 90,787 |
| Customer accounts | *29* | **1,722,000** | 1,423,519 |
| Trading liabilities | *30* | **168,299** | 182,870 |
| Financial liabilities designated at fair value | *31* | **3,366** | 2,838 |
| Derivatives | *16* | **170,993** | 99,170 |
| Debt securities in issue | *32* | **48,183** | 34,494 |
| Retirement benefit liabilities | *5m* | **875** | 447 |
| Amounts due to group companies | | **100,966** | 47,601 |
| Other liabilities and provisions | *33* | **52,848** | 45,253 |
| Current tax liabilities | *6* | **3,430** | 2,412 |
| Deferred tax liabilities | *35* | **2,402** | 1,679 |
| Subordinated liabilities | *37* | **9,811** | 9,721 |
| Preference shares | *38* | **90,328** | 76,464 |
| **Total liabilities** | | **2,631,286** | 2,170,247 |
| **EQUITY** | | | |
| Share capital | *39* | **22,494** | 22,494 |
| Other reserves | *40* | **61,260** | 26,923 |
| Retained profits | *40* | **58,096** | 41,866 |
| Proposed fourth interim dividend | *8* | **6,500** | 6,500 |
| Total equity | | **148,350** | 97,783 |
| **Total equity and liabilities** | | **2,779,636** | 2,268,030 |

*Directors*
Vincent H C Cheng
Alexander A Flockhart
Peter T S Wong

*Secretary*
M W Scales

# Consolidated Statement of Recognised Income and Expense for the Year Ended 31 December 2007

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Available-for-sale investments: | | |
| – fair value changes taken to equity | **35,801** | 25,115 |
| – fair value changes transferred to the income statement on disposal or impairment | **(959)** | (1,464) |
| – fair value changes transferred to the income statement on hedged items due to hedged risk | **(594)** | (105) |
| Cash flow hedges: | | |
| – fair value changes taken to equity | **555** | (165) |
| – fair value changes transferred to the income statement | **632** | 2,277 |
| Property revaluation: | | |
| – fair value changes taken to equity | **3,291** | 1,977 |
| Share of changes in equity of associates and joint ventures | **14** | (186) |
| Exchange differences | **6,292** | 2,779 |
| Actuarial (losses)/ gains on post-employment benefits | **(3,568)** | 93 |
| | **41,464** | 30,321 |
| Net deferred tax on items taken directly to equity | **45** | (738) |
| **Total income and expense taken to equity during the year** | **41,509** | 29,583 |
| **Profit for the year** | **65,305** | 42,605 |
| **Total recognised income and expense for the year** | **106,814** | 72,188 |
| **Total recognised income and expense for the year attributable to:** | | |
| – shareholders | **98,085** | 66,448 |
| – minority interests | **8,729** | 5,740 |
| | **106,814** | 72,188 |

# Consolidated Cash Flow Statement for the Year Ended 31 December 2007

| | Note | **2007 HK$m** | 2006 HK$m |
|---|---|---|---|
| **Operating activities** | | | |
| Cash generated from operations | *43* | **292,331** | 88,942 |
| Interest received on financial investments | | **21,393** | 17,527 |
| Dividends received on financial investments | | **585** | 711 |
| Dividends received from associates | | **1,208** | 766 |
| Taxation paid | | **(11,942)** | (6,159) |
| **Net cash inflow from operating activities** | | **303,575** | 101,787 |
| **Investing activities** | | | |
| Purchase of financial investments | | **(436,191)** | (402,459) |
| Proceeds from sale or redemption of financial investments | | **443,128** | 361,794 |
| Purchase of property, plant and equipment | | **(3,197)** | (2,085) |
| Proceeds from sale of property, plant and equipment and assets held for sale | | **1,214** | 4,176 |
| Purchase of other intangible assets | | **(1,271)** | (1,142) |
| Net cash outflow in respect of the acquisition of and increased shareholding in subsidiary companies | *44c* | **(134)** | (22) |
| Net cash inflow in respect of the sale of subsidiary companies | *44d* | **111** | 409 |
| Net cash inflow / (outflow) in respect of the purchase of interests in business portfolios | *44f* | **1,999** | (775) |
| Net cash outflow in respect of the purchase of interests in associates and joint ventures | | **(3,628)** | (462) |
| Proceeds from the sale of interests in business portfolios | *44e* | **1,948** | 16,501 |
| Proceeds from the sale of interests in associates | | **238** | – |
| **Net cash inflow / (outflow) from investing activities** | | **4,217** | (24,065) |
| **Net cash inflow before financing** | | **307,792** | 77,722 |
| **Financing** | | | |
| Issue of preference share capital | | **13,587** | 4,277 |
| Change in minority interests | | **688** | 976 |
| Repayment of subordinated liabilities | | **(463)** | (1,018) |
| Issue of subordinated liabilities | | **2,345** | 4,661 |
| Ordinary dividends paid | | **(23,000)** | (18,757) |
| Dividends paid to minority interests | | **(5,153)** | (3,841) |
| Interest paid on preference shares | | **(5,144)** | (3,935) |
| Interest paid on subordinated liabilities | | **(1,166)** | (946) |
| **Net cash outflow from financing** | | **(18,306)** | (18,583) |
| **Increase in cash and cash equivalents** | *44a* | **289,486** | 59,139 |

# 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 2007.

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 2007.

## 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 4, 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.

*Determination of fair value of financial instruments carried at fair value*

Fair values are determined according to the following hierarchy:

(a) Quoted market price

Financial instruments with quoted prices for identical instruments in active markets.

(b) Valuation technique using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(c) Valuation technique with significant non-observable inputs

Financial instruments valued using models where one or more significant inputs are not observable.

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are not observable. For these instruments, the fair value measurement derived is more judgemental. 'Not observable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (historical data may, for example, be used). Furthermore, the assessment of hierarchy level is based on the lowest level of input that is significant to the fair value of the financial instrument. Consequently, the level of uncertainty in the determination of the unobservable inputs will generally give rise to valuation uncertainty that is less than the fair value itself.

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

In certain circumstances, the group applies the fair value option to own debt in issue. Where available, the fair value will be based upon quoted prices in an active market for the specific instrument concerned. Where not available, the fair value will either be based upon quoted prices in an inactive market for the specific instrument concerned, or estimated by comparison with quoted prices in an active market for similar instruments. The fair value of these instruments therefore includes the effect of own credit spread. Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt.

Issued structured notes and certain other hybrid instrument liabilities are included within trading liabilities, and marked at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes. These market spreads are significantly tighter than credit spreads observed in vanilla debt or credit default swap markets.

All net positions in non-derivative financial instruments, and all derivative portfolios, are valued at bid or offer as appropriate. Long positions are marked at bid; short positions are marked at offer.

The fair values of large holdings of non-derivative financial instruments are based on a multiple of the value of a single instrument, and do not include block adjustments for the size of the holding.

The valuation models used where quoted market prices are not available incorporate certain assumptions that the group anticipates would be used by a market participant to establish fair value. Where the group anticipates that there are additional considerations not included within the valuation model, adjustments may be adopted outside the model. Examples of such adjustments are:

- Credit risk adjustment: an adjustment to reflect the credit worthiness of OTC derivative counterparties.
- Market data/model uncertainty: an adjustment to reflect uncertainties in fair values based on uncertain market data inputs (e.g. as a result of illiquidity) or in areas where the choice of valuation model is particularly subjective.
- Inception profit ('day 1 P&L reserves'): for financial instruments valued, at inception, on the basis of one or more significant unobservable inputs, the difference between transaction price and model value (as adjusted) at inception is not recognised in the consolidated income statement, but is deferred and included as part of the fair value.

Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage, fee expense, and post-trade costs are included in operating expenses. The future cost of administering the over-the-counter derivative portfolio is also not included in fair value, but is expensed as incurred.

- Loans

  Loans are valued from broker quotes and/or market data consensus providers where available. Where unavailable, fair value will be determined based on an appropriate credit spread derived from other market instruments issued by the same or comparable entities.

- Debt securities, Treasury and eligible bills, and Equities

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

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

- Derivatives

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

  The group's private equity positions are generally classified as available-for-sale and are not traded in an active market. In the absence of an active market for the investment, fair value is estimated based upon an analysis of the investee's financial position and results, risk profile, prospects and other factors as well as reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. The exercise of judgement is required and because of uncertainties inherent in estimating fair value for private equity investments, it is not until realisation of the investment that subjective valuation factors are removed.

*Fair value of financial instruments carried at amortised cost*

Accounting standards also require disclosure of the estimated fair value of certain financial instruments that are stated in the balance sheet at amortised cost. The estimation of fair value of some of these financial instruments for disclosure purposes is performed in the absence of active markets for instruments with similar characteristics.

- Loans and advances to customers

  The fair value of advances to customers is estimated using discounted cash flow models, using an estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

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

- Deposits and customer accounts

  The fair value of deposits and customer accounts is estimated using discounted cash flows, applying current rates offered for deposits of similar securities. The fair value of deposits repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

- Debt securities in issue and subordinated liabilities

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

*Loan impairment*

Application of the group's methodology for assessing loan impairment, as set out in note 4d, 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.

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

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, the assessment of the extent to which historical losses are representative of current conditions and the ongoing refinement of modelling methodologies provide a means of identifying changes that may be required, but the process is inherently one of estimation.

*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 24b. 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 34.

*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.

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

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 4g, 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 2007 are disclosed in notes 12 and 20a.

## 3 Comparative figures

Certain comparative figures have not been provided where the current year is the first year of disclosure and provision is impracticable.

## 4 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. Such transaction costs (for example, mortgage rebates) are incremental to the group and are directly attributable to a transaction.

Interest on impaired financial assets is recognised at the original effective interest rate of the financial asset applied to the impaired carrying amount. The accounting policy for recognising impairment of loans and advances is set out in note 4d 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 4a).

**4 Principal accounting policies** *(continued)*

*(ii) Dividend income*

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

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**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 (notes 4e and 4f).

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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;

**4 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.

**4 Principal accounting policies** *(continued)*

- 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.

**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 4f) 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.

**4 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 4a.

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

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

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’.

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 4f. 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.

**4 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.

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.

**4 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 4v.

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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.

**4 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. Property interests which are held under operating leases to earn rentals, or for capital appreciation or, both, are classified and accounted for as investment property on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 4p).

*(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 4o 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.

**4 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 is 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 recognised income and expense 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.

**4 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'.

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**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.

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**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.

## Notes on the Financial Statements (continued)

**4 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.

## 4 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.

## 5 Operating profit

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

**a** *Interest income*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Interest income on listed securities | **6,456** | 5,140 |
| Interest income on unlisted securities | **28,771** | 22,112 |
| Other interest income | **121,569** | 98,205 |
| | **156,796** | 125,457 |
| Less: interest income classified as 'Net trading income' (note 5d) | **(12,041)** | (9,073) |
| Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 5e) | **(602)** | (456) |
| | **144,153** | 115,928 |

Included in the above is interest income accrued on impaired financial assets of HK$400 million (*2006:HK$309 million*), including unwinding of discounts on loan impairment losses of HK$308 million *(2006:HK$196 million).*

## Notes on the Financial Statements (continued)

**5 Operating profit** *(continued)*

**b** *Interest expense*

| | **2007** **HK$m** | 2006 HK$m |
|---|---|---|
| Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years | **2,111** | 1,451 |
| Interest expense on preference shares | **5,346** | 4,512 |
| Other interest expense | **83,430** | 69,333 |
| | **90,887** | 75,296 |
| Less: interest expense classified as 'Net trading income' (note 5d) | **(9,363)** | (10,380) |
| Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 5e) | **(132)** | (87) |
| | **81,392** | 64,829 |

**c** *Net fee income*

| | **2007** **HK$m** | 2006 HK$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 | **9,404** | 8,543 |
| – fee expense | **(877)** | (1,292) |
| | **8,527** | 7,251 |
| Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers | | |
| – fee income | **9,078** | 6,221 |
| – fee expense | **(863)** | (516) |
| | **8,215** | 5,705 |

## 5 Operating profit *(continued)*

**d** *Net trading income*

| | **2007** **HK$m** | 2006 HK$m |
|---|---|---|
| Dealing profits | | |
| – Foreign exchange | **8,650** | 6,995 |
| – Interest rate derivatives | **1,677** | 1,171 |
| – Debt securities | **(48)** | 281 |
| – Equities and other trading | **2,552** | 1,554 |
| | **12,831** | 10,001 |
| Gain/(loss) from hedging activities | | |
| Fair value hedges | | |
| – Net gain on hedged items attributable to the hedged risk | **563** | 116 |
| – Net loss on hedging instruments | **(498)** | (95) |
| Cash flow hedges | | |
| – Net hedging loss | **(2)** | (5) |
| | **63** | 16 |
| Interest on trading assets and liabilities | | |
| – Interest income (note 5a) | **12,041** | 9,073 |
| – Interest expense (note 5b) | **(9,363)** | (10,380) |
| | **2,678** | (1,307) |
| Dividend income from trading securities | | |
| – Listed investments | **484** | 208 |
| | **16,056** | 8,918 |

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

| | **2007** **HK$m** | 2006 HK$m |
|---|---|---|
| Income on assets designated at fair value which back insurance and investment contracts | **8,405** | 4,977 |
| Change in fair value of investment contracts relating to insurance entities | **(2,740)** | (2,687) |
| | **5,665** | 2,290 |
| Net change in fair value of other financial assets/liabilities designated at fair value [1] | **66** | 11 |
| Interest on financial assets and liabilities designated at fair value | | |
| – Interest income (note 5a) | **602** | 456 |
| – Interest expense (note 5b) | **(132)** | (87) |
| | **470** | 369 |
| | **6,201** | 2,670 |

1 *Gains and losses from changes in the fair value of the Group's issued debt securities may arise from changes in the Group's own credit risk. In 2007 the group recognised a HK$12 million gain on changes in the fair value of these instruments arising from changes in own credit risk (2006: Nil).*

# Notes on the Financial Statements (continued)

## 5 Operating profit *(continued)*

**f** *Gains less losses from financial investments*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Gains on disposal of available-for-sale securities | **892** | 1,466 |

**g** *Gains arising from dilution of investments in associates*

During the period, three associates of the group, Bank of Communications Limited, Industrial Bank Co., Ltd. and Vietnam Technological and Commercial Joint Stock Bank ('Techcombank') issued new shares. The group did not subscribe for any additional shares issued under these offers and, as a result, its interests in the associates' equity decreased from 19.90 per cent to 18.60 per cent, from 15.98 per cent to 12.78 per cent and from 15 per cent to 14.54 per cent respectively.

The net assets of both Bank of Communications and Industrial Bank increased substantially when they received the proceeds from the new share issues. After the new issues, the group's share of the net assets of the three associates increased by HK$4,735 million compared to the share of the net assets immediately prior. This increase in the group's share of net assets was regarded as a gain arising from deemed disposals of part of its interest in the associates and has been presented in the consolidated income statement.

The gains resulting from the dilution of the group's investments in the associates were HK$3,228 million for Bank of Communications, HK$1,465 million for Industrial Bank and HK$42 million for Techcombank.

The dilution of the interests does not affect the classification of the group's investments as investments in associates.

**h** *Dividend income*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Listed investments | **463** | 273 |
| Unlisted investments | **230** | 476 |
| | **693** | 749 |

## 5 Operating profit *(continued)*

### i *Net earned insurance premiums*

| **2007** | *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** |
|---|---|---|---|---|---|
| Gross written premiums | **2,373** | **19,058** | **11,599** | **48** | **33,078** |
| Movement in unearned premiums | **(130)** | **–** | **–** | **–** | **(130)** |
| Gross earned premiums | **2,243** | **19,058** | **11,599** | **48** | **32,948** |
| Gross written premiums ceded to reinsurers | **(361)** | **(154)** | **(8,720)** | **–** | **(9,235)** |
| Reinsurers' share of movement in unearned premiums | **(18)** | **–** | **–** | **–** | **(18)** |
| Reinsurers' share of gross earned premiums | **(379)** | **(154)** | **(8,720)** | **–** | **(9,253)** |
| Net earned premiums | **1,864** | **18,904** | **2,879** | **48** | **23,695** |

| 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 |
|---|---|---|---|---|---|
| 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 |

**5 Operating profit** *(continued)*

**j** *Other operating income*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Rental income from investment properties | **151** | 196 |
| Movement in present value of in-force insurance business | **950** | 1,124 |
| Gains on investment properties | **564** | 475 |
| Profit on disposal of property, plant and equipment, and assets held for sale | **64** | 981 |
| Profit on disposal of subsidiaries, associates and business portfolios | **96** | 904 |
| Surplus arising on property revaluation | **122** | 70 |
| Other | **2,109** | 1,903 |
| | **4,056** | 5,653 |

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

## 5 **Operating profit** *(continued)*

### k *Net insurance claims incurred and movement in policyholders' liabilities*

| **2007** | *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 | **903** | **1,950** | **3,940** | **1** | **6,794** |
| Movement in provision | **(40)** | **18,904** | **10,010** | **108** | **28,982** |
| Gross claims incurred and movement in policyholders' liabilities | **863** | **20,854** | **13,950** | **109** | **35,776** |
| Reinsurers' share of claims, benefits and surrenders paid | **(83)** | **(48)** | **(218)** | **–** | **(349)** |
| Reinsurers' share of movement in provision | **25** | **(22)** | **(8,409)** | **–** | **(8,406)** |
| Reinsurers' share of claims incurred and movement in policyholders' liabilities | **(58)** | **(70)** | **(8,627)** | **–** | **(8,755)** |
| Net insurance claims incurred and movement in policyholders' liabilities | **805** | **20,784** | **5,323** | **109** | **27,021** |

| 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 |

## Notes on the Financial Statements (continued)

### 5 Operating profit *(continued)*

**l** *Loan impairment charges and other credit risk provisions*

| | 2007 | 2006 |
|---|---|---|
| Net charge for impairment of customer advances | HK$m | HK$m |
| – Individually assessed impairment allowances: | | |
| New allowances | 1,884 | 1,314 |
| Releases | (646) | (869) |
| Recoveries | (197) | (212) |
| | 1,041 | 233 |
| – Net charge for collectively assessed impairment allowances | 4,619 | 4,468 |
| Net charge for other credit risk provisions | 145 | 108 |
| Net charge for loan impairment and other credit risk provisions | 5,805 | 4,809 |

Included in the net charge for other credit risk provisions is an impairment charge of HK$5 million against an available-for-sale investment (*2006: HK$80 million*). There are no impairment losses or provisions relating to held-to-maturity investments.

**m** *Employee compensation and benefits*

| | 2007 | 2006 |
|---|---|---|
| | HK$m | HK$m |
| Wages, salaries and other costs | 16,687 | 14,302 |
| Performance-related pay | 8,317 | 5,501 |
| Social security costs | 327 | 283 |
| Retirement benefit costs | | |
| – Defined contribution plans | 628 | 447 |
| – Defined benefit plans | 472 | 509 |
| | 26,431 | 21,042 |

*Retirement benefit pension plans*

The group operates 66 *(2006: 56)* retirement benefits plans, with a total cost of HK$1,100 million *(2006: HK$956 million)*, of which HK$494 million *(2006: HK$313 million)* relates to overseas plans and HK$72 million *(2006:HK$48 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 45% *(2006: 47%)* 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$442 million *(2006: HK$457 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.

## 5 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:

| | **2007** | 2006 |
|---|---|---|
| | **% p.a.** | % p.a. |
| Discount rate | **3.45** | 3.75 |
| Expected rate of return on plan assets | | |
| – equities | **8.3** | 8.0 |
| – bonds | **4.5** | 4.0 |
| – other | **6.1** | 5.0 |
| Rate of pay increase | | |
| – long term | **5.0** | 3.0 |
| Mortality table | HKLT2001* | HKLT2001* |

* *HKLT2001 – Hong Kong Life Tables 2001*

The overall expected long-term rate of return on assets as at 31 December 2007 is 7.2%. The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The return is based on historical market returns adjusted for additional factors such as the current rate of inflation and interest rates.

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of The Hongkong and Shanghai Banking Corporation and certain other employees of HSBC Group. The latest actuarial valuation of the defined benefit plan was made at 31 December 2006. At the valuation date, the market value of the defined benefit scheme's assets was HK$8,624 million. On an ongoing basis, the actuarial value of the scheme's assets represented 119 per cent of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries, and the resulting surplus amounted to HK$1,353 million. On a wind-up basis, the scheme's assets represented 126 per cent of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK$1,773 million. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 4 per cent per annum and long-term salary increases of 3 per cent per annum (with short-term deviation from 2007 to 2008).

## Notes on the Financial Statements (continued)

**5 Operating profit** *(continued)*

*(ii) Value recognised in the balance sheet*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Equities | **6,954** | 5,865 | **4,568** | 3,088 |
| Bonds | **7,310** | 6,620 | **4,579** | 4,364 |
| Other | **2,308** | 2,375 | **1,359** | 2,048 |
| Fair value of plan assets | **16,572** | 14,860 | **10,506** | 9,500 |
| Present value of funded obligations | **17,830** | 12,830 | **11,184** | 8,382 |
| Present value of unfunded obligations | **136** | 304 | **126** | 292 |
| Defined benefit obligations | **17,966** | 13,134 | **11,310** | 8,674 |
| Effect of limit on plan surpluses | **20** | – | **20** | – |
| Net defined benefit (liability)/asset | **(1,414)** | 1,726 | **(824)** | 826 |
| Reported as 'Assets' | **123** | 2,191 | **51** | 1,273 |
| Reported as 'Liabilities' | **(1,537)** | (465) | **(875)** | (447) |
| Net defined benefit (liability)/asset | **(1,414)** | 1,726 | **(824)** | 826 |

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

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| At 1 January | **13,134** | 11,950 | **8,674** | 7,726 |
| Current service cost | **859** | 720 | **614** | 481 |
| Interest cost | **512** | 511 | **348** | 336 |
| Contributions by employees | **2** | 2 | **–** | 1 |
| Actuarial losses | **4,496** | 860 | **2,374** | 672 |
| Benefits paid | **(1,101)** | (914) | **(769)** | (563) |
| Gains on curtailments | **(18)** | (1) | **(17)** | – |
| Exchange and other movements | **82** | 6 | **86** | 21 |
| At 31 December | **17,966** | 13,134 | **11,310** | 8,674 |

**5 Operating profit** *(continued)*

*(iv) Changes in the fair value of plan assets*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| At 1 January | **14,860** | 13,344 | **9,500** | 8,599 |
| Expected return | **881** | 721 | **497** | 441 |
| Contributions by the group | **851** | 667 | **660** | 438 |
| Contributions by employees | **2** | 2 | **–** | 1 |
| Actuarial gains | **948** | 953 | **487** | 499 |
| Benefits paid | **(1,050)** | (840) | **(729)** | (489) |
| Exchange and other movements | **80** | 13 | **91** | 11 |
| At 31 December | **16,572** | 14,860 | **10,506** | 9,500 |

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

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Equities | **583** | 589 | **516** | 522 |
| Others | **8** | 4 | **4** | – |
| | **591** | 593 | **520** | 522 |

The actual return on plan assets for the year ended 31 December 2007 was HK$1,829 million *(2006: HK$1,674 million)*.

The group expects to make HK$748 million of contributions to defined benefit pension plans during the following year *(2006: HK$669 million)*. Contributions to be made by the Bank are expected to be HK$561 million *(2006: HK$443 million)*.

**5 Operating profit** *(continued)*

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

| | Group | |
|---|---|---|
| | **2007** | 2006 |
| | **HK$m** | HK$m |
| Current service cost | **859** | 720 |
| Interest cost | **512** | 511 |
| Expected return on plan assets | **(881)** | (721) |
| Gains on curtailments and settlements | **(18)** | (1) |
| Total net expense | **472** | 509 |

Total net actuarial losses recognised in the group's total equity during 2007 in respect of defined benefit pension plans was HK$3,568 million *(2006: HK$93 million gain)*. After deduction of minority interests, a loss of HK$2,998 million *(2006: HK$8 million loss)* was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date was HK$3,384 million *(2006: HK$184 million gain)*. After deduction of minority interests, the total net actuarial losses recognised in total shareholders' equity to date was HK$2,949 million *(2006: HK$49 million gain)*.

Total net actuarial losses recognised in the Bank's retained profits during 2007 in respect of defined benefit pension plans were HK$1,906 million *(2006: HK$173 million loss)*. Total net actuarial losses recognised outside of the income statement to date were HK$2,102 million *(2006: HK$196 million loss)*.

The total effect of the limit on plan surpluses, recognised within actuarial losses in both the group and the Bank's retained profits, during 2007 in respect of defined benefit pension plans was HK$20 million *(2006: HK$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 as these are reported as Defined Contribution Plans.

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

The scheme is denominated in Sterling with the following details:

| Assumptions as at 31 December | **2007** | 2006 |
|---|---|---|
| | **% p.a.** | % p.a. |
| Inflation | **3.30** | 3.00 |
| Salary increases | **5.05** | 4.75 |
| Pension increases | **3.30** | 3.00 |
| Discount rate | **5.80** | 5.10 |
| Expected return on assets | **5.77** | 5.89 |
| Mortality table | **PA92YOB*** | PA92C2005** |

* *The table "PA92 Year of Birth" was based on the 92 series of tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries and allowing for future improvements in mortality after 1992 in line with those underlying the medium cohort improvements applicable to the series.*

** *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.*

**5 Operating profit** *(continued)*

*The International Staff Scheme*

| Funded status at 31 December | **2007** | 2006 |
|---|---|---|
| | **£m** | £m |
| Plan assets | **525** | 504 |
| Defined benefit obligations | **(619)** | (601) |
| Net defined benefit liabilities | **(94)** | (97) |

| Categories of assets at 31 December | **2007** | 2006 |
|---|---|---|
| | **£m** | £m |
| Bonds | **376** | 423 |
| Property | **48** | 49 |
| Other | **101** | 32 |
| Fair value of plan assets | **525** | 504 |

| Reconciliation of defined benefit obligations at 31 December | **2007** | 2006 |
|---|---|---|
| | **£m** | £m |
| At 1 January | **601** | 575 |
| Current service cost | **15** | 17 |
| Interest cost | **30** | 27 |
| Contributions by employees | **1** | 1 |
| Actuarial losses | **13** | 26 |
| Benefits paid | **(41)** | (47) |
| Special termination benefit cost | **–** | 2 |
| At 31 December | **619** | 601 |

| Reconciliation of the fair value of plan assets at 31 December | **2007** | 2006 |
|---|---|---|
| | **£m** | £m |
| At 1 January | **504** | 510 |
| Expected return | **29** | 24 |
| Actuarial gains/(losses) | **19** | (8) |
| Contributions by the group | **13** | 24 |
| Contributions by employees | **1** | 1 |
| Benefits paid | **(41)** | (47) |
| At 31 December | **525** | 504 |

| Estimated contributions in the following year | **2007** | 2006 |
|---|---|---|
| | **£m** | £m |
| Estimated company contributions in the financial year | **14** | 15 |
| Estimated employee contributions in the financial year | **1** | 1 |
| Estimated total contributions in the financial year | **15** | 16 |

## Notes on the Financial Statements (continued)

**5 Operating profit** *(continued)*

*(vi) Amounts for the current and previous years*

| | Group | | | | | Bank | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **2007** | 2006 | 2005 | 2004 | 2003 | **2007** | 2006 | 2005 | 2004 | 2003 |
| | **HK$m** | HK$m | HK$m | HK$m | HK$m | **HK$m** | HK$m | HK$m | HK$m | HK$m |
| Defined benefit obligations | **17,966** | 13,134 | 11,950 | 11,626 | 10,329 | **11,310** | 8,674 | 7,726 | 7,389 | 6,714 |
| Plan assets | **16,572** | 14,860 | 13,344 | 12,606 | 11,561 | **10,506** | 9,500 | 8,599 | 8,095 | 7,534 |
| Net (deficit)/surplus | **(1,394)** | 1,726 | 1,394 | 980 | 1,232 | **(804)** | 826 | 873 | 706 | 820 |
| Experience losses/(gains) on plan liabilities | **790** | 420 | 84 | (28) | (281) | **585** | 384 | 71 | (76) | (230) |
| Experience gains/(losses) on plan assets | **948** | 953 | 67 | 99 | 611 | **487** | 499 | (5) | 9 | 283 |

**n** *General and administrative expenses*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Premises and equipment | | |
| – Rental expenses | **1,957** | 1,557 |
| – Amortisation of prepaid operating lease payments | **59** | 58 |
| – Other premises and equipment | **2,750** | 2,463 |
| | **4,766** | 4,078 |
| Marketing and advertising expenses | **4,170** | 3,587 |
| Other administrative expenses | **9,537** | 7,268 |
| Litigation and other provisions | **(434)** | 16 |
| | **18,039** | 14,949 |

Included in operating expenses are direct operating expenses of HK$21 million *(2006: HK$27 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$1 million *(2006: HK$3 million)*.

Included in operating expenses are minimum lease payments under operating leases of HK$1,918 million *(2006: HK$1,497 million)*.

**o** *Auditors' remuneration*

Auditors' remuneration amounted to HK$62 million *(2006: HK$58 million),* of which HK$27 million *(2006: HK$29 million)* related to the Bank.

**p** *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$125 million *(2006: HK$137 million)*. This comprises fees of HK$6 million *(2006: HK$7 million)* and other emoluments of HK$119 million *(2006: HK$130 million)* which includes pension benefits of HK$5 million *(2006: HK$4 million)*.

## 6 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% *(2006: 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 2007. Deferred taxation is provided for in accordance with the group's accounting policy in note 4q.

The charge for taxation in the income statement comprises:

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Current income tax | | |
| – Hong Kong profits tax – on current year profit | **8,723** | 5,664 |
| – Hong Kong profits tax – adjustments in respect of prior years | **(444)** | (158) |
| – Overseas taxation – on current year profit | **4,835** | 4,192 |
| – Overseas taxation – adjustments in respect of prior years | **(184)** | (237) |
| | **12,930** | 9,461 |
| Deferred tax (note 35) | | |
| – Origination and reversal of temporary differences | **224** | (142) |
| – Adjustments in respect of prior years | **302** | 92 |
| | **526** | (50) |
| | **13,456** | 9,411 |

**b** *Provisions for taxation*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Hong Kong profits tax | **3,322** | 2,229 | **1,409** | 598 |
| Overseas taxation | **2,511** | 2,271 | **2,021** | 1,814 |
| Current tax liabilities | **5,833** | 4,500 | **3,430** | 2,412 |
| Deferred tax liabilities (note 35) | **5,148** | 4,284 | **2,402** | 1,679 |
| | **10,981** | 8,784 | **5,832** | 4,091 |

**6 Tax expense** *(continued)*

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

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Profit before tax | **78,761** | 52,016 |
| Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned | **14,699** | 9,952 |
| Tax effect of non-taxable revenue (net of non-deductible expenses) | **(789)** | (260) |
| Tax effect of prior year's tax losses utilised this year (net of unused tax losses not recognised) | **(127)** | (86) |
| Over provision in prior years | **(326)** | (303) |
| Others | **(1)** | 108 |
| | **13,456** | 9,411 |

**7 Profit attributable to shareholders**

The consolidated profit attributable to shareholders includes a profit of HK$40,601 million *(2006: HK$32,532 million)* which has been dealt with in the accounts of the Bank.

**8 Dividends**

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **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 | **0.72** | **6,500** | 0.50 | 4,500 |
| – first interim dividend paid | **0.56** | **5,000** | 0.42 | 3,757 |
| – second interim dividend paid | **0.61** | **5,500** | 0.61 | 5,500 |
| – third interim dividend paid | **0.67** | **6,000** | 0.55 | 5,000 |
| | **2.56** | **23,000** | 2.08 | 18,757 |

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2007 of HK$6,500 million (HK$0.72 per ordinary share).

## 9 Financial Assets and Liabilities

*Group*

| | At 31 December 2007 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | *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 | - | - | - | **618,214** | **163,880** | **12,829** | - | - | **794,923** |
| Items in the course of collection from other banks | - | - | - | - | - | **20,357** | - | - | **20,357** |
| Placings with banks maturing after one month | - | - | - | **60,328** | - | - | - | - | **60,328** |
| Certificates of deposit | - | - | **2,887** | - | **94,471** | - | - | - | **97,358** |
| Hong Kong SAR Government certificates of indebtedness | - | - | - | - | - | **108,344** | - | - | **108,344** |
| Trading assets | **360,704** | - | - | - | - | - | - | - | **360,704** |
| Financial assets designated at fair value | - | **63,152** | - | - | - | - | - | - | **63,152** |
| Derivatives | **173,984** | - | - | - | - | - | **331** | **6,125** | **180,440** |
| Advances to customers | - | - | - | **1,212,086** | - | - | - | - | **1,212,086** |
| Financial investments | - | - | **45,243** | - | **487,000** | - | - | - | **532,243** |
| Amounts due from group companies | **123,869** | **1** | - | - | - | **240,854** | - | - | **364,724** |
| Other assets | - | - | - | - | - | **59,513** | - | - | **59,513** |
| **Total financial assets** | **658,557** | **63,153** | **48,130** | **1,890,628** | **745,351** | **441,897** | **331** | **6,125** | **3,854,172** |
| **LIABILITIES** | | | | | | | | | |
| Hong Kong SAR currency notes in circulation | - | - | - | - | - | **108,344** | - | - | **108,344** |
| Items in the course of transmission to other banks | - | - | - | - | - | **31,586** | - | - | **31,586** |
| Deposits by banks | - | - | - | - | - | **169,177** | - | - | **169,177** |
| Customer accounts | - | - | - | - | - | **2,486,106** | - | - | **2,486,106** |
| Trading liabilities | **265,675** | - | - | - | - | - | - | - | **265,675** |
| Financial liabilities designated at fair value | - | **38,147** | - | - | - | - | - | - | **38,147** |
| Derivatives | **172,357** | - | - | - | - | - | **586** | **379** | **173,322** |
| Debt securities in issue | - | - | - | - | - | **84,523** | - | - | **84,523** |
| Amounts due to group companies | **18,306** | **1** | - | - | - | **47,539** | - | - | **65,846** |
| Other liabilities | - | - | - | - | - | **67,097** | - | - | **67,097** |
| Subordinated liabilities | - | - | - | - | - | **18,500** | - | - | **18,500** |
| Preference shares | - | - | - | - | - | **90,328** | - | - | **90,328** |
| **Total financial liabilities** | **456,338** | **38,148** | - | - | - | **3,103,200** | **586** | **379** | **3,598,651** |

## 9 Financial Assets and Liabilities *(continued)*

*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 |

## 9 Financial Assets and Liabilities *(continued)*

*Bank*

| | At 31 December 2007 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | *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 | - | - | - | **468,052** | **160,739** | **8,980** | - | - | **637,771** |
| Items in the course of collection from other banks | - | - | - | - | - | **13,946** | - | - | **13,946** |
| Placings with banks maturing after one month | - | - | - | **39,842** | - | - | - | - | **39,842** |
| Certificates of deposit | - | - | - | - | **48,788** | - | - | - | **48,788** |
| Hong Kong SAR Government certificates of indebtedness | - | - | - | - | - | **108,344** | - | - | **108,344** |
| Trading assets | **260,107** | - | - | - | - | - | - | - | **260,107** |
| Financial assets designated at fair value | - | **2,861** | - | - | - | - | - | - | **2,861** |
| Derivatives | **173,193** | - | - | - | - | - | **241** | **4,750** | **178,184** |
| Advances to customers | - | - | - | **743,530** | - | - | - | - | **743,530** |
| Financial investments | - | - | - | - | **254,225** | - | - | - | **254,225** |
| Amounts due from group companies | **129,778** | - | - | - | - | **251,458** | - | - | **381,236** |
| Other assets | - | - | - | - | - | **41,571** | - | - | **41,571** |
| **Total financial assets** | **563,078** | **2,861** | - | **1,251,424** | **463,752** | **424,299** | **241** | **4,750** | **2,710,405** |
| | | | | | | | | | |
| **LIABILITIES** | | | | | | | | | |
| Hong Kong SAR currency notes in circulation | - | - | - | - | - | **108,344** | - | - | **108,344** |
| Items in the course of transmission to other banks | - | - | - | - | - | **22,837** | - | - | **22,837** |
| Deposits by banks | - | - | - | - | - | **126,604** | - | - | **126,604** |
| Customer accounts | - | - | - | - | - | **1,722,000** | - | - | **1,722,000** |
| Trading liabilities | **168,299** | - | - | - | - | - | - | - | **168,299** |
| Financial liabilities designated at fair value | - | **3,366** | - | - | - | - | - | - | **3,366** |
| Derivatives | **170,187** | - | - | - | - | - | **461** | **345** | **170,993** |
| Debt securities in issue | - | - | - | - | - | **48,183** | - | - | **48,183** |
| Amounts due to group companies | **35,924** | - | - | - | - | **65,042** | - | - | **100,966** |
| Other liabilities | - | - | - | - | - | **50,812** | - | - | **50,812** |
| Subordinated liabilities | - | - | - | - | - | **9,811** | - | - | **9,811** |
| Preference shares | - | - | - | - | - | **90,328** | - | - | **90,328** |
| **Total financial liabilities** | **374,410** | **3,366** | - | - | - | **2,243,961** | **461** | **345** | **2,622,543** |

## Notes on the Financial Statements (continued)

### 9 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 |

## 10 Cash and short-term funds

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Cash in hand and current balances with banks | **42,155** | 30,990 | **27,048** | 19,629 |
| Balances with central banks | **34,282** | 17,043 | **14,710** | 14,777 |
| Placings with banks with remaining maturity of one month or less | **554,606** | 361,267 | **435,274** | 284,164 |
| Treasury bills and other eligible bills | **163,880** | 108,722 | **160,739** | 107,606 |
| | **794,923** | 518,022 | **637,771** | 426,176 |

Deposits required by overseas government regulations included in cash and short-term funds and placings with banks maturing after one month (note 11) are as follows:

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Balances with banks and central banks | **31,451** | 19,177 | **21,011** | 18,374 |
| Treasury bills and other eligible bills | **1,792** | 314 | **1,711** | 236 |
| | **33,243** | 19,491 | **22,722** | 18,610 |

Treasury bills and other eligible bills are analysed as follows:

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Treasury bills and other eligible bills – available-for-sale | | | | |
| – which may be repledged or resold by counterparties | **–** | 25 | **–** | 25 |
| – which may not be repledged or resold or are not subject to repledge or resale by counterparties | **163,880** | 108,697 | **160,739** | 107,581 |
| | **163,880** | 108,722 | **160,739** | 107,606 |

Treasury bills and other eligible bills held for trading are included under 'Trading assets' (note 14). All treasury bills and other eligible bills are unlisted.

## 11 Placings with banks

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Gross placings with banks maturing after one month but less than one year | **56,640** | 99,332 | **36,863** | 74,544 |
| Gross placings with banks maturing after one year | **3,688** | 4,705 | **2,979** | 4,705 |
| Total placings with banks | **60,328** | 104,037 | **39,842** | 79,249 |
| Fair value | **60,385** | 104,069 | **39,899** | 79,283 |

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

# Notes on the Financial Statements (continued)

## 12 Certificates of deposit

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Held-to-maturity – at amortised cost | **2,887** | 2,912 | **–** | – |
| Available-for-sale | **94,471** | 70,288 | **48,788** | 33,907 |
| | **97,358** | 73,200 | **48,788** | 33,907 |
| Held-to-maturity – fair value | **2,933** | 2,941 | **–** | – |

Certificates of deposit held are largely unlisted.

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

## 13 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.

## 14 Trading assets

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Trading assets | | | | |
| – which may be repledged or resold by counterparties | **13,659** | 10,599 | **580** | 469 |
| – which may not be repledged or resold or are not subject to repledge or resale by counterparties | **347,045** | 328,193 | **259,527** | 283,588 |
| | **360,704** | 338,792 | **260,107** | 284,057 |

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Debt securities | **173,067** | 140,252 | **106,670** | 103,565 |
| Equity shares | **33,561** | 23,101 | **32,315** | 20,816 |
| Treasury bills and other eligible bills | **108,888** | 152,816 | **102,169** | 146,744 |
| Other | **45,188** | 22,623 | **18,953** | 12,932 |
| | **360,704** | 338,792 | **260,107** | 284,057 |

All treasury bills and other eligible bills are unlisted.

## 14 Trading assets *(continued)*

**a** *Debt securities*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Listed | | | | |
| – listed in Hong Kong | **24,076** | 24,475 | **21,512** | 21,350 |
| – listed outside Hong Kong | **39,181** | 37,282 | **17,619** | 28,537 |
| | **63,257** | 61,757 | **39,131** | 49,887 |
| Unlisted | **109,810** | 78,495 | **67,539** | 53,678 |
| | **173,067** | 140,252 | **106,670** | 103,565 |
| Issued by public bodies | | | | |
| – central governments and central banks | **102,920** | 70,963 | **55,593** | 49,046 |
| – other public sector entities | **3,046** | 5,392 | **2,652** | 4,104 |
| | **105,966** | 76,355 | **58,245** | 53,150 |
| Issued by other bodies | | | | |
| – banks | **34,201** | 26,937 | **18,500** | 17,257 |
| – corporate entities | **32,900** | 36,960 | **29,925** | 33,158 |
| | **173,067** | 140,252 | **106,670** | 103,565 |

**b** *Equity shares*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Listed | | | | |
| – listed in Hong Kong | **22,832** | 7,459 | **22,830** | 7,443 |
| – listed outside Hong Kong | **3,552** | 6,529 | **3,552** | 6,529 |
| | **26,384** | 13,988 | **26,382** | 13,972 |
| Unlisted | **7,177** | 9,113 | **5,933** | 6,844 |
| | **33,561** | 23,101 | **32,315** | 20,816 |
| Issued by other bodies | | | | |
| – banks | **3,636** | 2,880 | **3,636** | 2,880 |
| – corporate entities | **29,925** | 20,221 | **28,679** | 17,936 |
| | **33,561** | 23,101 | **32,315** | 20,816 |

## 15 Financial assets designated at fair value

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Debt securities | **19,589** | 22,939 | **2,843** | 10,766 |
| Equity shares | **43,545** | 27,159 | **–** | – |
| Other | **18** | 416 | **18** | 416 |
| | **63,152** | 50,514 | **2,861** | 11,182 |

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

**a** *Debt securities*

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Listed | | | | |
| – listed in Hong Kong | **2,983** | 1,833 | **778** | 978 |
| – listed outside Hong Kong | **5,294** | 2,699 | **1,351** | 1,297 |
| | **8,277** | 4,532 | **2,129** | 2,275 |
| Unlisted | **11,312** | 18,407 | **714** | 8,491 |
| | **19,589** | 22,939 | **2,843** | 10,766 |

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Issued by public bodies | | | | |
| – central governments and central banks | **6,396** | 4,247 | **851** | 1,527 |
| – other public sector entities | **1,611** | 1,183 | **267** | 357 |
| | **8,007** | 5,430 | **1,118** | 1,884 |
| Issued by other bodies | | | | |
| – banks | **7,197** | 13,571 | **76** | 6,804 |
| – corporate entities | **4,385** | 3,938 | **1,649** | 2,078 |
| | **19,589** | 22,939 | **2,843** | 10,766 |

**b** *Equity shares*

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Listed | | | | |
| – listed in Hong Kong | **9,140** | 6,609 | **–** | – |
| – listed outside Hong Kong | **14,587** | 13,910 | **–** | – |
| | **23,727** | 20,519 | **–** | – |
| Unlisted | **19,818** | 6,640 | **–** | – |
| | **43,545** | 27,159 | **–** | – |
| Issued by other bodies | | | | |
| – banks | **3** | 3 | **–** | – |
| – corporate entities | **43,542** | 27,156 | **–** | – |
| | **43,545** | 27,159 | **–** | – |

**16 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.

**16 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 4j.

**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*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Group* | *Bank* | *Group* | *Bank* |
| | **HK$m** | **HK$m** | HK$m | HK$m |
| Exchange rate | **7,357,202** | **6,728,698** | 4,526,572 | 4,226,254 |
| Interest rate | **10,651,066** | **10,573,561** | 7,469,197 | 7,401,165 |
| Equities | **312,162** | **301,807** | 136,281 | 145,726 |
| Credit derivatives | **709,173** | **707,737** | 401,070 | 400,027 |
| Commodity and other | **15,724** | **14,287** | 20,038 | 19,739 |
| Total derivatives | **19,045,327** | **18,326,090** | 12,553,158 | 12,192,911 |

## Notes on the Financial Statements (continued)

**16 Derivatives** *(continued)*

Other derivatives classified as held for trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge ineffectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes and do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value and are included in the table above.

*(ii) Fair values of outstanding trading derivatives*

*Group*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **Assets HK$m** | **Liabilities HK$m** | Assets HK$m | Liabilities HK$m |
| Exchange rate | **72,322** | **71,904** | 42,862 | 41,468 |
| Interest rate | **73,778** | **71,522** | 42,389 | 40,599 |
| Equities | **21,197** | **23,902** | 6,351 | 11,734 |
| Credit derivatives | **6,588** | **4,602** | 3,024 | 3,502 |
| Commodity and other | **99** | **427** | 121 | 545 |
| Total derivatives | **173,984** | **172,357** | 94,747 | 97,848 |

*Bank*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **Assets HK$m** | **Liabilities HK$m** | Assets HK$m | Liabilities HK$m |
| Exchange rate | **70,577** | **70,299** | 42,194 | 41,016 |
| Interest rate | **73,636** | **71,193** | 42,318 | 40,286 |
| Equities | **22,118** | **23,669** | 6,355 | 13,245 |
| Credit derivatives | **6,544** | **4,600** | 3,025 | 3,506 |
| Commodity and other | **318** | **426** | 370 | 545 |
| Total derivatives | **173,193** | **170,187** | 94,262 | 98,598 |

*(iii) Risk exposure by counterparty type*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Group* % | *Bank* % | *Group* % | *Bank* % |
| Government | **1** | **1** | 1 | 1 |
| Banks | **75** | **75** | 68 | 68 |
| Other financial institutions | **11** | **11** | 14 | 14 |
| Other | **13** | **13** | 17 | 17 |
| 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.

## 16 Derivatives *(continued)*

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

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **Cash flow hedge HK$m** | **Fair value hedge HK$m** | **Cash flow hedge HK$m** | **Fair value hedge HK$m** |
| **31 December 2007** | | | | |
| Foreign exchange | **2,984** | **–** | **2,984** | **–** |
| Interest rate | **336,726** | **59,482** | **260,975** | **47,622** |
| Total derivatives | **339,710** | **59,482** | **263,959** | **47,622** |

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | Cash flow hedge HK$m | Fair value hedge HK$m | Cash flow hedge HK$m | Fair value hedge HK$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 |

*(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 2007** | | | | |
| Interest rate | **331** | **586** | **241** | **461** |

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | Assets HK$m | Liabilities HK$m | Assets HK$m | Liabilities HK$m |
| 31 December 2006 | | | | |
| Interest rate | 672 | 493 | 396 | 411 |

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

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| **31 December 2007** | **Assets HK$m** | **Liabilities HK$m** | **Assets HK$m** | **Liabilities HK$m** |
| Foreign exchange | **–** | **335** | **–** | **335** |
| Interest rate | **6,125** | **44** | **4,750** | **10** |
| | **6,125** | **379** | **4,750** | **345** |

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

The cash flows of the above hedging derivatives are expected to affect the income statement in 2008 and beyond.

## Notes on the Financial Statements (continued)

**16 Derivatives** *(continued)*

The group's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their own contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised directly in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. The group does not enter into forecast transactions on non-financial assets and liabilities.

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the year to 31 December 2007, a loss of HK$2 million *(2006: HK$5 million)* was recognised due to hedge ineffectiveness and termination of forecast transactions.

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2007 is as follows:

| | **3 months or less HK$m** | **More than 3 months but less than 1 year HK$m** | **5 years or less but more than 1 year HK$m** |
|---|---|---|---|
| **At 31 December 2007** | | | |
| Cash inflows from assets | **307,875** | **197,030** | **17,065** |
| Cash outflows from liabilities | **(10,014)** | **(12,873)** | **(10,818)** |
| Net cash inflows | **297,861** | **184,157** | **6,247** |
| | | | |
| At 31 December 2006 | | | |
| Cash inflows from assets | 218,792 | 165,891 | 15,459 |
| Cash outflows from liabilities | (10,366) | (10,164) | (6,711) |
| Net cash inflows | 208,426 | 155,727 | 8,748 |

## 16 Derivatives *(continued)*

**c** *Unobservable inception profits*

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

The table below sets out the aggregate 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*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Balance at 1 January | **108** | 103 |
| Deferrals on new transactions | **975** | 93 |
| Reduction due to amortisation | **(166)** | (4) |
| Reduction due to redemption/sales/transfers/improved observability/risk hedged | **(420)** | (88) |
| Exchange differences and others | **(1)** | 4 |
| Balance at 31 December | **496** | 108 |

*Bank*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Balance at 1 January | **110** | 103 |
| Deferrals on new transactions | **975** | 93 |
| Reduction due to amortisation | **(166)** | (4) |
| Reduction due to redemption/sales/transfers/improved observability/risk hedged | **(420)** | (88) |
| Exchange differences and others | **(1)** | 6 |
| Balance at 31 December | **498** | 110 |

## 17 Advances to customers

**a** *Advances to customers*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Gross advances to customers | **1,219,346** | 1,050,625 | **749,254** | 692,170 |
| Impairment allowances (note 18a) | **(7,260)** | (6,843) | **(5,724)** | (5,702) |
| | **1,212,086** | 1,043,782 | **743,530** | 686,468 |
| Fair value | **1,214,117** | 1,045,594 | **743,443** | 686,392 |

Included in advances to customers are:

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Trade bills | **66,518** | 53,559 | **54,470** | 45,252 |
| Individually assessed impairment allowances | **(160)** | (104) | **(153)** | (96) |
| | **66,358** | 53,455 | **54,317** | 45,156 |

# Notes on the Financial Statements (continued)

## 17 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*

| **2007** | *Hong Kong* | *Rest of Asia-Pacific* | *Americas/ Europe* | *Total* |
|---|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| Residential mortgages | **197,712** | **128,650** | **4** | **326,366** |
| Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages | **30,738** | **–** | **–** | **30,738** |
| Credit card advances | **35,279** | **25,926** | **–** | **61,205** |
| Other personal | **41,567** | **40,115** | **1** | **81,683** |
| Total personal | **305,296** | **194,691** | **5** | **499,992** |
| Commercial, industrial and international trade | **138,331** | **200,475** | **–** | **338,806** |
| Commercial real estate | **94,748** | **46,391** | **–** | **141,139** |
| Other property-related lending | **63,697** | **20,936** | **–** | **84,633** |
| Government | **2,587** | **6,338** | **–** | **8,925** |
| Other commercial | **40,369** | **52,752** | **–** | **93,121** |
| Total corporate and commercial | **339,732** | **326,892** | **–** | **666,624** |
| Non-bank financial institutions | **19,363** | **29,344** | **–** | **48,707** |
| Settlement accounts | **3,798** | **225** | **–** | **4,023** |
| Total financial | **23,161** | **29,569** | **–** | **52,730** |
| Gross advances to customers | **668,189** | **551,152** | **5** | **1,219,346** |
| Individually assessed impairment allowances | **(1,028)** | **(1,154)** | **–** | **(2,182)** |
| Collectively assessed impairment allowances | **(1,904)** | **(3,174)** | **–** | **(5,078)** |
| Net advances to customers | **665,257** | **546,824** | **5** | **1,212,086** |

**17 Advances to customers** *(continued)*

| 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 |
| Individually assessed impairment allowances | (1,016) | (1,102) | – | (2,118) |
| Collectively assessed impairment allowances | (1,822) | (2,903) | – | (4,725) |
| Net advances to customers | 631,398 | 412,378 | 6 | 1,043,782 |

*Bank*

| **2007** | *Hong Kong* | *Rest of Asia-Pacific* | *Americas/ Europe* | *Total* |
|---|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| Residential mortgages | **101,102** | **86,437** | **–** | **187,539** |
| Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages | **12,301** | – | **–** | **12,301** |
| Credit card advances | **23,924** | **20,768** | **–** | **44,692** |
| Other personal | **25,332** | **35,493** | **1** | **60,826** |
| Total personal | **162,659** | **142,698** | **1** | **305,358** |
| Commercial, industrial and international trade | **93,097** | **127,384** | **–** | **220,481** |
| Commercial real estate | **67,071** | **22,574** | **–** | **89,645** |
| Other property-related lending | **19,256** | **11,731** | **–** | **30,987** |
| Government | **1,392** | **4,685** | **–** | **6,077** |
| Other commercial | **20,514** | **37,816** | **–** | **58,330** |
| Total corporate and commercial | **201,330** | **204,190** | **–** | **405,520** |
| Non-bank financial institutions | **15,608** | **22,570** | **–** | **38,178** |
| Settlement accounts | **–** | **198** | **–** | **198** |
| Total financial | **15,608** | **22,768** | **–** | **38,376** |
| Gross advances to customers | **379,597** | **369,656** | **1** | **749,254** |
| Individually assessed impairment allowances | **(650)** | **(1,007)** | **–** | **(1,657)** |
| Collectively assessed impairment allowances | **(1,268)** | **(2,799)** | **–** | **(4,067)** |
| Net advances to customers | **377,679** | **365,850** | **1** | **743,530** |

# Notes on the Financial Statements (continued)

**17 Advances to customers** *(continued)*

| 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 |
| Individually assessed impairment allowances | (544) | (1,072) | – | (1,616) |
| Collectively assessed impairment allowances | (1,303) | (2,783) | – | (4,086) |
| Net advances to customers | 347,898 | 338,569 | 1 | 686,468 |

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.

**17 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* | | |
|---|---|---|---|
| | *Gross Advances* | | *Collateral and other security* |
| | **2007** | 2006 | **2007** |
| | **HK$m** | HK$m | **HK$m** |
| Gross advances to customers for use in Hong Kong | | | |
| *Industrial, commercial and financial* | | | |
| Property development | **47,217** | 46,352 | **12,198** |
| Property investment | **116,331** | 99,580 | **86,658** |
| Financial concerns | **10,731** | 10,136 | **1,588** |
| Stockbrokers | **2,669** | 964 | **544** |
| Wholesale and retail trade | **38,502** | 36,101 | **12,164** |
| Manufacturing | **21,526** | 17,331 | **4,424** |
| Transport and transport equipment | **26,381** | 27,408 | **18,388** |
| Recreational activities | **238** | 442 | **12** |
| Information technology | **2,504** | 2,494 | **27** |
| Others | **40,674** | 40,676 | **14,864** |
| | **306,773** | 281,484 | **150,867** |
| *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 | **30,738** | 31,708 | **30,686** |
| Advances for the purchase of other residential properties | **176,591** | 171,014 | **176,123** |
| Credit card advances | **35,279** | 31,315 | **–** |
| Others | **37,188** | 26,966 | **16,078** |
| | **279,796** | 261,003 | **222,887** |
| Gross advances to customers for use in Hong Kong | **586,569** | 542,487 | **373,754** |
| Trade finance | **65,149** | 56,121 | **22,007** |
| Gross advances to customers for use outside Hong Kong made by branches of the Bank and subsidiary companies in Hong Kong | **16,471** | 35,628 | **2,639** |
| Gross advances to customers made by branches of the Bank and subsidiary companies in Hong Kong | **668,189** | 634,236 | **398,400** |
| Gross advances to customers made by branches of the Bank and subsidiary companies outside Hong Kong | | | |
| – rest of Asia-Pacific | **551,152** | 416,383 | **217,710** |
| – Americas/Europe | **5** | 6 | **–** |
| Gross advances to customers | **1,219,346** | 1,050,625 | **616,110** |

# Notes on the Financial Statements (continued)

**17 Advances to customers** *(continued)*

| | Bank | | |
|---|---|---|---|
| | *Gross Advances* | | *Collateral and other security* |
| | **2007 HK$m** | 2006 HK$m | **2007 HK$m** |
| Gross advances to customers for use in Hong Kong | | | |
| *Industrial, commercial and financial* | | | |
| Property development | **26,248** | 28,301 | **4,958** |
| Property investment | **61,629** | 51,442 | **40,531** |
| Financial concerns | **7,225** | 7,875 | **939** |
| Stockbrokers | **2,145** | 730 | **115** |
| Wholesale and retail trade | **32,293** | 29,692 | **9,330** |
| Manufacturing | **12,941** | 9,595 | **1,919** |
| Transport and transport equipment | **16,960** | 16,162 | **11,787** |
| Recreational activities | **20** | 232 | **9** |
| Information technology | **1,591** | 2,016 | **6** |
| Others | **18,312** | 16,637 | **3,715** |
| | **179,364** | 162,682 | **73,309** |
| *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 | **12,301** | 11,629 | **12,278** |
| Advances for the purchase of other residential properties | **90,668** | 87,399 | **90,558** |
| Credit card advances | **23,924** | 21,867 | **–** |
| Others | **21,191** | 16,294 | **9,243** |
| | **148,084** | 137,189 | **112,079** |
| Gross advances to customers for use in Hong Kong | **327,448** | 299,871 | **185,388** |
| Trade finance | **42,154** | 36,437 | **14,493** |
| Gross advances to customers for use outside Hong Kong made by branches of the Bank in Hong Kong | **9,995** | 13,437 | **1,053** |
| Gross advances to customers made by branches of the Bank in Hong Kong | **379,597** | 349,745 | **200,934** |
| Gross advances to customers made by branches of the Bank outside Hong Kong | | | |
| – rest of Asia-Pacific | **369,656** | 342,424 | **139,645** |
| – Americas/Europe | **1** | 1 | **–** |
| Gross advances to customers | **749,254** | 692,170 | **340,579** |

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 17b.

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.

**17 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*

| | **2007** | | | 2006 | | |
|---|---|---|---|---|---|---|
| | *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 | **5,232** | **1,237** | **6,469** | 5,647 | 1,423 | 7,070 |
| – After one year but within five years | **10,471** | **2,880** | **13,351** | 12,941 | 3,325 | 16,266 |
| – After five years | **11,534** | **3,758** | **15,292** | 11,854 | 4,294 | 16,148 |
| | **27,237** | **7,875** | **35,112** | 30,442 | 9,042 | 39,484 |
| Impairment allowances | **(49)** | | | (70) | | |
| Net investment in finance leases and hire purchase contracts | **27,188** | | | 30,372 | | |

*Bank*

| | **2007** | | | 2006 | | |
|---|---|---|---|---|---|---|
| | *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 | **3,697** | **696** | **4,393** | 4,062 | 832 | 4,894 |
| – After one year but within five years | **6,999** | **1,579** | **8,578** | 9,224 | 1,909 | 11,133 |
| – After five years | **6,238** | **1,778** | **8,016** | 6,691 | 2,015 | 8,706 |
| | **16,934** | **4,053** | **20,987** | 19,977 | 4,756 | 24,733 |
| Impairment allowances | **(13)** | | | (22) | | |
| Net investment in finance leases and hire purchase contracts | **16,921** | | | 19,955 | | |

## Notes on the Financial Statements (continued)

### 18 Impairment allowances against advances to customers

**a** *Impairment allowances against advances to customers*

*Group*

| | *Individually assessed allowances* | *Collectively assessed allowances* | *Total* |
|---|---|---|---|
| **2007** | **HK$m** | **HK$m** | **HK$m** |
| At 1 January | **2,118** | **4,725** | **6,843** |
| Amounts written off | **(1,301)** | **(4,885)** | **(6,186)** |
| Recoveries of advances written off in previous years | **197** | **696** | **893** |
| Net charge to income statement (note 5l) | **1,041** | **4,619** | **5,660** |
| Unwinding of discount of loan impairment | **(89)** | **(219)** | **(308)** |
| Exchange and other adjustments | **216** | **142** | **358** |
| At 31 December | **2,182** | **5,078** | **7,260** |

| | *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 5l) | 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 |

*Bank*

| | *Individually assessed allowances* | *Collectively assessed allowances* | *Total* |
|---|---|---|---|
| **2007** | **HK$m** | **HK$m** | **HK$m** |
| At 1 January | **1,616** | **4,086** | **5,702** |
| Amounts written off | **(890)** | **(4,349)** | **(5,239)** |
| Recoveries of advances written off in previous years | **173** | **591** | **764** |
| Net charge to income statement | **747** | **4,062** | **4,809** |
| Unwinding of discount of loan impairment | **(71)** | **(219)** | **(290)** |
| Exchange and other adjustments | **82** | **(104)** | **(22)** |
| At 31 December | **1,657** | **4,067** | **5,724** |

| | *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 |

## 18 Impairment allowances against advances to customers *(continued)*

**b** *Impaired advances to customers and allowances*

*Group*

| **2007** | *Hong Kong* **HK$m** | *Rest of Asia-Pacific* **HK$m** | *Total* **HK$m** |
|---|---|---|---|
| Impairment allowance charge | **1,654** | **4,006** | **5,660** |
| Advances to customers which are considered to be impaired are as follows:– | | | |
| Gross impaired advances | **3,380** | **5,003** | **8,383** |
| Individually assessed allowances | **(1,028)** | **(1,154)** | **(2,182)** |
| | **2,352** | **3,849** | **6,201** |
| Individually assessed allowances as a percentage of gross impaired advances | **30.4%** | **23.1%** | **26.0%** |
| Gross impaired advances as a percentage of gross advances to customers | **0.5%** | **0.9%** | **0.7%** |

| 2006 | *Hong Kong* HK$m | *Rest of Asia-Pacific* HK$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% |

# Notes on the Financial Statements (continued)

## 18 Impairment allowances against advances to customers *(continued)*

*Bank*

| 2007 | *Hong Kong* HK$m | *Rest of Asia-Pacific* HK$m | *Total* HK$m |
|---|---|---|---|
| Impairment allowance charge | **1,117** | **3,692** | **4,809** |
| Advances to customers which are considered to be impaired are as follows:– | | | |
| Gross impaired advances | **2,329** | **4,210** | **6,539** |
| Individually assessed allowances | **(650)** | **(1,007)** | **(1,657)** |
| | **1,679** | **3,203** | **4,882** |
| Individually assessed allowances as a percentage of gross impaired advances | **27.9%** | **23.9%** | **25.3%** |
| Gross impaired advances as a percentage of gross advances to customers | **0.6%** | **1.1%** | **0.9%** |

| 2006 | *Hong Kong* HK$m | *Rest of Asia-Pacific* HK$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% |

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.

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

**c** *Individually assessed impaired advances*

| *Group* | *Hong Kong* | *Rest of Asia-Pacific* | *Total* |
|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** |
| **31 December 2007** | | | |
| Gross individually assessed impaired advances | **2,950** | **2,686** | **5,636** |
| Individually assessed impairment allowances | **(1,028)** | **(1,154)** | **(2,182)** |
| | **1,922** | **1,532** | **3,454** |
| Gross individually assessed impaired advances as a percentage of gross advances to customers | **0.4%** | **0.5%** | **0.5%** |
| Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers | **1,973** | **1,406** | **3,379** |
| 31 December 2006 | | | |
| Gross individually assessed impaired advances | 3,176 | 2,178 | 5,354 |
| Individually assessed impairment allowances | (1,016) | (1,102) | (2,118) |
| | 2,160 | 1,076 | 3,236 |
| Gross individually assessed impaired advances as a percentage of gross advances to customers | 0.5% | 0.5% | 0.5% |

| *Bank* | *Hong Kong* | *Rest of Asia-Pacific* | *Total* |
|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** |
| **31 December 2007** | | | |
| Gross individually assessed impaired advances | **1,977** | **2,000** | **3,977** |
| Individually assessed impairment allowances | **(650)** | **(1,007)** | **(1,657)** |
| | **1,327** | **993** | **2,320** |
| Gross individually assessed impaired advances as a percentage of gross advances to customers | **0.5%** | **0.5%** | **0.5%** |
| Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers | **1,293** | **1,075** | **2,368** |

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

## Notes on the Financial Statements (continued)

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

| 31 December 2006 | *Hong Kong* HK$m | *Rest of Asia-Pacific* HK$m | *Total* HK$m |
|---|---|---|---|
| Gross individually assessed impaired advances | 1,758 | 1,986 | 3,744 |
| Individually assessed impairment allowances | (544) | (1,072) | (1,616) |
| | 1,214 | 914 | 2,128 |
| Gross individually assessed impaired advances as a percentage of gross advances to customers | 0.5% | 0.6% | 0.5% |

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

| *Group*<br>*Figures in HK$m* | *Total gross advances* | *Gross impaired advances* | *Individually assessed allowances* | *Collectively assessed allowances* |
|---|---|---|---|---|
| **At 31 December 2007** | | | | |
| Residential mortgages | **326,366** | **2,066** | **(204)** | **(275)** |
| Commercial, industrial and international trade | **338,806** | **2,538** | **(1,617)** | **(1,553)** |
| Commercial real estate | **141,139** | **84** | **(11)** | **(54)** |
| At 31 December 2006 | | | | |
| Residential mortgages | 304,427 | 2,097 | (264) | (315) |
| Commercial, industrial and international trade | 264,554 | 1,906 | (1,327) | (1,527) |
| Commercial real estate | 130,758 | 166 | (59) | (64) |

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

| *Bank*<br>*Figures in HK$m* | *Total gross advances* | *Gross impaired advances* | *Individually assessed allowances* | *Collectively assessed allowances* |
|---|---|---|---|---|
| **At 31 December 2007** | | | | |
| Residential mortgages | **187,539** | **1,456** | **(156)** | **(178)** |
| Commercial, industrial and international trade | **220,481** | **1,757** | **(1,199)** | **(1,071)** |
| Commercial real estate | **89,645** | **63** | **(11)** | **(47)** |
| At 31 December 2006 | | | | |
| Residential mortgages | 181,725 | 1,463 | (200) | (205) |
| Commercial, industrial and international trade | 200,793 | 1,456 | (1,023) | (1,256) |
| Commercial real estate | 88,514 | 75 | (58) | (56) |

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

**d** *Overdue advances to customers*

*Group*

| | *Hong Kong* | | *Rest of Asia-Pacific* | | *Total* | |
|---|---|---|---|---|---|---|
| **2007** | **HK$m** | **%** | **HK$m** | **%** | **HK$m** | **%** |
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of | | | | | | |
| – more than three months but not more than six months | **737** | **0.1** | **1,403** | **0.3** | **2,140** | **0.2** |
| – more than six months but not more than one year | **223** | **0.0** | **837** | **0.2** | **1,060** | **0.1** |
| – more than one year | **637** | **0.1** | **1,042** | **0.2** | **1,679** | **0.1** |
| | **1,597** | **0.2** | **3,282** | **0.7** | **4,879** | **0.4** |
| Individually assessed impairment allowances made in respect of such overdue advances | **(418)** | | **(787)** | | **(1,205)** | |
| Amount of collateral held in respect of overdue advances | **1,118** | | **1,266** | | **2,384** | |

## Notes on the Financial Statements (continued)

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

| 2006 | *Hong Kong* HK$m | % | *Rest of Asia-Pacific* HK$m | % | *Total* HK$m | % |
|---|---|---|---|---|---|---|
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of | | | | | | |
| – more than three months but not more than six months | 938 | 0.1 | 1,287 | 0.3 | 2,225 | 0.2 |
| – more than six months but not more than one year | 384 | 0.1 | 595 | 0.1 | 979 | 0.1 |
| – more than 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 |
| Individually assessed impairment allowances made in respect of such overdue advances | (645) | | (754) | | (1,399) | |

*Bank*

| **2007** | *Hong Kong* **HK$m** | **%** | *Rest of Asia-Pacific* **HK$m** | **%** | *Total* **HK$m** | **%** |
|---|---|---|---|---|---|---|
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of | | | | | | |
| – more than three months but not more than six months | **408** | **0.1** | **1,155** | **0.3** | **1,563** | **0.2** |
| – more than six months but not more than one year | **122** | **0.0** | **431** | **0.1** | **553** | **0.1** |
| – more than one year | **524** | **0.1** | **755** | **0.2** | **1,279** | **0.2** |
| | **1,054** | **0.2** | **2,341** | **0.6** | **3,395** | **0.5** |
| Individually assessed impairment allowances made in respect of such overdue advances | **(179)** | | **(644)** | | **(823)** | |
| Amount of collateral held in respect of overdue advances | **717** | | **781** | | **1,498** | |

## 18 Impairment allowances against advances to customers *(continued)*

| 2006 | *Hong Kong* HK$m | % | *Rest of Asia-Pacific* HK$m | % | *Total* HK$m | % |
|---|---|---|---|---|---|---|
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of | | | | | | |
| – more than three months but not more than six months | 434 | 0.1 | 1,068 | 0.3 | 1,502 | 0.2 |
| – more than six months but not more than one year | 121 | 0.0 | 494 | 0.2 | 615 | 0.1 |
| – more than one year | 998 | 0.3 | 775 | 0.2 | 1,773 | 0.3 |
| | 1,553 | 0.4 | 2,337 | 0.7 | 3,890 | 0.6 |
| Individually assessed impairment allowances made in respect of such overdue advances | (254) | | (730) | | (984) | |

**e** *Rescheduled advances to customers*

*Group*

| | *Hong Kong* HK$m | % | *Rest of Asia-Pacific* HK$m | % | *Total* HK$m | % |
|---|---|---|---|---|---|---|
| **2007** | **1,610** | **0.2** | **1,620** | **0.3** | **3,230** | **0.3** |
| 2006 | 1,730 | 0.3 | 2,307 | 0.6 | 4,037 | 0.4 |

*Bank*

| | *Hong Kong* HK$m | % | *Rest of Asia-Pacific* HK$m | % | *Total* HK$m | % |
|---|---|---|---|---|---|---|
| **2007** | **1,258** | **0.3** | **1,521** | **0.4** | **2,779** | **0.4** |
| 2006 | 1,373 | 0.4 | 2,293 | 0.7 | 3,666 | 0.5 |

Rescheduled advances to customers are those advances which have been restructured or renegotiated because of a deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule.

Rescheduled advances to customers are stated net of any advances which have subsequently become overdue for more than three months and which are included in ‘Overdue advances to customers’ (note 18d).

## 19 Impairment allowances against advances to banks and other assets

There are no significant impaired, overdue or rescheduled advances to banks or overdue or rescheduled other assets as at 31 December 2007 and 31 December 2006.

# Notes on the Financial Statements (continued)

## 20 Financial investments

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Financial investments | | | | |
| – which may be repledged or resold by counterparties | **5,637** | 124 | **4,380** | 124 |
| – which may not be repledged or resold or are not subject to repledge or resale by counterparties | **526,606** | 484,717 | **249,845** | 243,099 |
| | **532,243** | 484,841 | **254,225** | 243,223 |

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Debt securities | | | | |
| – available-for-sale | **404,992** | 404,853 | **189,023** | 208,442 |
| – held-to-maturity | **45,243** | 40,407 | **–** | – |
| Equity shares | | | | |
| – available-for-sale | **82,008** | 39,581 | **65,202** | 34,781 |
| | **532,243** | 484,841 | **254,225** | 243,223 |

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

*Group*

| | Book value | | Fair value | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Listed | | | | |
| – listed in Hong Kong | **367** | 392 | **377** | 400 |
| – listed outside Hong Kong | **3,085** | 3,286 | **3,203** | 3,322 |
| | **3,452** | 3,678 | **3,580** | 3,722 |
| Unlisted | **41,791** | 36,729 | **42,879** | 37,428 |
| | **45,243** | 40,407 | **46,459** | 41,150 |

| | Book value | | Fair value | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Issued by public bodies | | | | |
| – central governments and central banks | **1,436** | 1,195 | **1,506** | 1,207 |
| – other public sector entities | **1,889** | 1,790 | **1,980** | 1,874 |
| | **3,325** | 2,985 | **3,486** | 3,081 |
| Issued by other bodies | | | | |
| – banks | **39,910** | 35,344 | **40,930** | 35,953 |
| – corporate entities | **2,008** | 2,078 | **2,043** | 2,116 |
| | **45,243** | 40,407 | **46,459** | 41,150 |

## 20 Financial investments *(continued)*

**b** *Available-for-sale debt securities*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006* | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Listed | | | | |
| – listed in Hong Kong | **7,023** | 8,565 | **2,487** | 1,951 |
| – listed outside Hong Kong | **115,048** | 130,386 | **44,973** | 59,499 |
| | **122,071** | 138,951 | **47,460** | 61,450 |
| Unlisted | **282,921** | 265,902 | **141,563** | 146,992 |
| | **404,992** | 404,853 | **189,023** | 208,442 |

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Issued by public bodies | | | | |
| – central governments and central banks | **59,412** | 41,988 | **38,295** | 34,394 |
| – other public sector entities | **13,075** | 16,776 | **8,024** | 10,183 |
| | **72,487** | 58,764 | **46,319** | 44,577 |
| Issued by other bodies | | | | |
| – banks | **300,975** | 310,976 | **125,336** | 146,624 |
| – corporate entities | **31,530** | 35,113 | **17,368** | 17,241 |
| | **404,992** | 404,853 | **189,023** | 208,442 |

* *Certain comparative figures have been reclassified to conform with the current year's presentation*

**c** *Available-for-sale equity shares*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Listed | | | | |
| – listed in Hong Kong | **57,606** | 29,210 | **51,451** | 26,523 |
| – listed outside Hong Kong | **1,627** | 2,601 | **1,218** | 1,127 |
| | **59,233** | 31,811 | **52,669** | 27,650 |
| Unlisted | **22,775** | 7,770 | **12,533** | 7,131 |
| | **82,008** | 39,581 | **65,202** | 34,781 |

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Issued by other bodies | | | | |
| – banks | **11,843** | 4,877 | **6,873** | 3,523 |
| – corporate entities | **70,165** | 34,704 | **58,329** | 31,258 |
| | **82,008** | 39,581 | **65,202** | 34,781 |

# Notes on the Financial Statements (continued)

## 21 Securitisations and other structured transactions

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

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

The majority of financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets that did not qualify for derecognition during 2007 and 2006, and their associated financial liabilities:

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Carrying amount of transferred assets* **HK$m** | *Carrying amount of associated liabilities* **HK$m** | *Carrying amount of transferred assets* HK$m | *Carrying amount of associated liabilities* HK$m |
| Repurchase agreements | **1,895** | **1,843** | 5,179 | 6,143 |
| Securities lending agreements | **17,400** | **13,132** | 12,315 | 6,212 |
| | **19,295** | **14,975** | 17,494 | 12,355 |

## 22 Investments in subsidiary companies

| | Bank 2007 HK$m | Bank 2006 HK$m |
|---|---|---|
| Investment in subsidiary companies – at cost | | |
| Unlisted investments | **15,509** | 6,963 |
| Listed investment | **865** | 865 |
| | **16,374** | 7,828 |
| Market value of listed investments | | |

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 (China) Company Limited | People's Republic of China | Banking | RMB8,000m | 100% |
| 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.

The following agreements have been entered into to acquire businesses that are expected to be effected after the date these financial statements are authorised for issue, subject to regulatory approval.

*Agreement to acquire Korea Exchange Bank*

In September 2007, the group agreed to acquire 51.02 per cent of the issued share capital of Korea Exchange Bank ('KEB') from LSF-KEB Holdings SCA, a holding company owned by Lone Star Fund IV (US) LP and Lone Star Fund IV (Bermuda) LP (collectively 'Lone Star'). The consideration is KRW3,400 billion plus US$2,833million, amounting in total to the equivalent of approximately US$6,450million, payable in cash.

Under a shareholders' agreement with Lone Star, The Export-Import Bank of Korea ('KEXIM') is entitled to require the group to purchase, on substantially the same terms, part or all of its shareholding in KEB (KEXIM's entire shareholding represents a further 6.25 per cent of the issued share capital of KEB).

The acquisition is subject to a number of conditions including the receipt of applicable governmental and regulatory approvals, particularly in South Korea from the Financial Supervisory Commission and the Fair Trade Commission.

The acquisition agreement is conditional on completion taking place on or before 30 April 2008.

Following completion, KEB will be accounted for as a subsidiary in the group's consolidated financial statements.

# Notes on the Financial Statements (continued)

## 22 Investments in subsidiary companies *(continued)*

*Acquisition of The Chinese Bank Co., Ltd.*

In December 2007, the group was named the successful bidder in a government auction to acquire the business of The Chinese Bank Co., Ltd. ('The Chinese Bank') in Taiwan.

The agreement relating to this acquisition will result in the group assuming The Chinese Bank's assets, liabilities and operations with a payment by the Taiwan Government's Central Deposit Insurance Corporation to deliver an agreed net asset position. In addition, the group will provide certain additional capital of between US$300 million to US$400 million to ensure that its enlarged operations maintain appropriate financial ratios.

The transaction is subject to obtaining the necessary regulatory approvals.

## 23 Investments in associates and joint ventures

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Unlisted investments | **–** | – | **1,080** | 520 |
| Listed investment | **–** | – | **19,381** | 16,988 |
| Share of net assets | **33,952** | 21,361 | **–** | – |
| Goodwill | **3,837** | 2,370 | **–** | – |
| Intangible assets | **2,789** | 2,691 | **–** | – |
| Deferred tax on intangible assets | **(746)** | (888) | **–** | – |
| | **39,832** | 25,534 | **20,461** | 17,508 |

**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 Co., Ltd | People's Republic of China | Banking | RMB48,994m | 19.01% |
| Industrial Bank Co., Ltd.* | People's Republic of China | Banking | RMB5,000m | 12.78% |
| **Unlisted** | | | | |
| Barrowgate Limited* | Hong Kong SAR | Property investment | 1 | 24.64% |
| Vietnam Technological and Commercial Joint Stock Bank | Vietnam | Banking | VND 2,521bn | 14.44% |

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

## 23 Investments in associates and joint ventures *(continued)*

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

Shareholdings in associated companies include listed investments of HK$19,381 million *(2006: HK$16,988 million)*. At the balance sheet date, the fair value of these investments, based on quoted market prices was HK$136,700 million *(2006: HK$86,046 million)*.

Hang Seng Bank Limited holds a 12.78 per cent stake in Industrial Bank Co., Ltd. and The Hongkong and Shanghai Banking Corporation Limited holds a 19.01 per cent interest in Bank of Communications Co.,Ltd. These companies are accounted for as associated companies, as the group has representation on the Board of Directors of each bank, and in accordance with the Technical Support and Assistance Agreements, is assisting in the development of financial and operating policies. In respect of Bank of Communications Co., Ltd, a number of staff have been seconded to assist in this process.

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

In respect of the year ended 31 December 2007, Bank of Communications Co., Ltd and Industrial Bank Co., Ltd were included in these financial statements based on financial statements drawn up to 30 September 2007, but taking into account any changes in the subsequent period from 1 October 2007 to 31 December 2007 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 names which are amortised over a period of 10 years.

During the first half of 2007, two of the group's associates, Industrial Bank and Bank of Communications, issued new 'A' shares which were listed on the Shanghai Stock Exchange. The group did not subscribe for any of the new shares issued and, as a result, its interests in the associates' equity decreased from 15.98% to 12.78% and from 19.90% to 18.60%, respectively.

The dilution of the interests does not affect the classification of the group's investments in Industrial Bank and Bank of Communications as "investments in associates" as there has been no change in the group's representation on the Boards of Directors or the continuing involvement of the group in the financial and operating policies of the associates through Technical Services Agreements.

During September and October 2007, the group purchased additional 'H' shares in Bank of Communications in the open market for an aggregate consideration of HK$ 2,392 million. This resulted in the group's interest in the equity of Bank of Communications increasing from 18.60% to 19.01%. These additional share purchases are reflected in the carrying amount of Investments in associates.

The group's 14.54% investment in Techcombank was equity accounted with effect from 1 October 2007, reflecting the group's significant influence over this associate. The group's significant influence was established as a result of the acquisition of an additional participation of 5.58% for a consideration of HK$258 million together with representation on the Board of Directors and involvement in the financial and operating policies of Techcombank through a Technical Services Agreement. The investment was subsequently diluted to 14.44%.

## Notes on the Financial Statements (continued)

**23 Investments in associates and joint ventures** *(continued)*

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

| | *Assets* HK$m | *Liabilities* HK$m | *Equity* HK$m | *Revenue* HK$m | *Expenses* HK$m | *Profit* HK$m |
|---|---|---|---|---|---|---|
| **2007** | | | | | | |
| 100 per cent | **3,316,192** | **3,132,528** | **183,664** | **80,734** | **54,216** | **26,518** |
| Group's effective interest[1] | **520,751** | **489,992** | **30,759** | **13,626** | **9,275** | **4,351** |
| 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 |

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

At 31 December 2007, the group's share of associates and joint ventures' contingent liabilities was HK$99,619 million *(2006: HK$73,412 million)*.

**c** *Movement in investments in associates and joint ventures*

| | **2007** *Group* HK$m | *Bank* HK$m |
|---|---|---|
| At 1 January | **25,534** | **17,508** |
| Additions | **3,834** | **2,953** |
| Disposals | **(329)** | **–** |
| Retained profits | **3,758** | **–** |
| Amortisation of intangible assets (net of deferred tax) | **(229)** | **–** |
| Reclassified as held for sale | **(16)** | **–** |
| Dilution gain | **4,735** | **–** |
| Exchange and other movements | **2,545** | **–** |
| At 31 December | **39,832** | **20,461** |

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

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

| *Group* | **2007** Highest balance during the year[1] HK$m | **2007** Balance at 31 December[1] HK$m | 2006 Highest balance during the year[1] HK$m | 2006 Balance at 31 December[1] HK$m |
|---|---|---|---|---|
| Amounts due from associates – unsubordinated | **54,826** | **4,335** | 2,102 | 530 |
| Amounts due from joint ventures – unsubordinated | **995** | **995** | 477 | 260 |
| Amounts due to associates | **39,439** | **1,864** | 1,495 | 1,191 |
| Amounts due to joint ventures | **340** | **14** | 338 | 338 |

## 23 Investments in associates and joint ventures *(continued)*

| *Bank* | **2007** Highest balance during the year [1] HK$m | **2007** Balance at 31 December [1] HK$m | 2006 Highest balance during the year [1] HK$m | 2006 Balance at 31 December [1] HK$m |
|---|---|---|---|---|
| Amounts due from associates | | | | |
| – unsubordinated | **32,485** | **963** | 1,496 | – |
| Amounts due from joint ventures | | | | |
| – unsubordinated | **995** | **995** | 477 | 260 |
| Amounts due to associates | **14,803** | **898** | 769 | 557 |
| Amounts due to joint ventures | **340** | **14** | 338 | 338 |

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

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

**e** *Investment in joint ventures*

The group holds 44% of the equity capital of a 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 2007, the company was equity accounted for based on financial statements made up to 30 November 2007, taking into account changes in the subsequent period from 1 December to 31 December 2007 that would have materially affected its results.

In 2007, the group entered into a joint agreement with HSBC Bank plc to establish HSBC Yen Investment Partners. The group holds 50% of the equity capital of the partnership and as a result the group together with the other shareholder, exercises joint control over the company.

## 24 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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Goodwill | **2,158** | 1,997 | **1,063** | 1,021 |
| The present value of in-force long-term assurance business | **6,824** | 5,841 | **–** | – |
| Other intangible assets | **3,327** | 2,590 | **2,964** | 2,339 |
| | **12,309** | 10,428 | **4,027** | 3,360 |

**a** *Goodwill*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Cost | | | | |
| At 1 January | **1,997** | 1,652 | **1,021** | 752 |
| Additions | **50** | 313 | **1** | 291 |
| Reclassified as held for sale | **(6)** | (33) | **(6)** | (33) |
| Exchange and other movements | **117** | 65 | **47** | 11 |
| At 31 December | **2,158** | 1,997 | **1,063** | 1,021 |
| | | | | |
| Net book value at 31 December | **2,158** | 1,997 | **1,063** | 1,021 |

*Geographical analysis of goodwill*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Hong Kong | **804** | 803 | **523** | 522 |
| Rest of Asia-Pacific | **1,354** | 1,194 | **540** | 499 |
| | **2,158** | 1,997 | **1,063** | 1,021 |

During 2007 there was no impairment of goodwill (*2006: HK$nil*). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs') determined at 1 July 2007 based on a value in use calculation. That calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current GDP and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the Group of the business units making up the CGUs. The discount rate used is based on the cost of capital HSBC allocates to investments in the countries within which the CGU operates.

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

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

**24 Goodwill and intangible assets** *(continued)*

**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:

| | **2007** | 2006 |
|---|---|---|
| Risk adjusted discount rate | **11.0%** | 11.0% |
| Expenses inflation | **3.0%** | 3.0% |
| Lapse rate | **1%-15% for the first policy year and 0%-15% 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* | |
|---|---|---|
| | **2007** | 2006 |
| | **HK$m** | HK$m |
| At 1 January | **5,841** | 4,685 |
| Addition from current year new business | **1,582** | 1,593 |
| Movement from in-force business | **(632)** | (469) |
| Exchange and other adjustments | **33** | 32 |
| At 31 December | **6,824** | 5,841 |

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

| | ***Impact on 2007 results*** | *Impact on 2006 results* |
|---|---|---|
| | **HK$m** | HK$m |
| + 100 basis points shift in risk free rate | **1,324** | 1,018 |
| - 100 basis points shift in risk free rate | **(1,437)** | (1,105) |
| + 100 basis points shift in risk adjusted discount rate | **(362)** | (287) |
| - 100 basis points shift in risk adjusted discount rate | **412** | 326 |
| + 100 basis points shift in expenses inflation | **(27)** | (20) |
| - 100 basis points shift in expenses inflation | **24** | 18 |
| + 100 basis points shift in lapse rate | **906** | 675 |
| - 100 basis points shift in lapse rate | **(942)** | (702) |

# Notes on the Financial Statements (continued)

## 24 Goodwill and intangible assets *(continued)*

**c** *Other intangible assets*

*Group*

| | *Computer software* | *Customer/ merchant relationships* | *Other* | *Total* |
|---|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| Cost | | | | |
| At 1 January 2007 | **2,560** | **1,082** | **7** | **3,649** |
| Additions | **1,268** | **28** | **3** | **1,299** |
| Disposals / amounts written-off | **(94)** | **–** | **–** | **(94)** |
| Exchange and other movements | **15** | **98** | **1** | **114** |
| At 31 December 2007 | **3,749** | **1,208** | **11** | **4,968** |
| | | | | |
| Accumulated amortisation and impairment | | | | |
| At 1 January 2007 | **982** | **74** | **3** | **1,059** |
| Amortisation charge for the year | **504** | **108** | **–** | **612** |
| Disposals / amounts written-off | **(49)** | **–** | **–** | **(49)** |
| Exchange and other movements | **12** | **7** | **–** | **19** |
| At 31 December 2007 | **1,449** | **189** | **3** | **1,641** |
| | | | | |
| Net book value at 31 December 2007 | **2,300** | **1,019** | **8** | **3,327** |

*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 / amounts written-off | (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 / amounts written-off | (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 |

**24 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 2007 | **2,239** | **1,022** | **3** | **3,264** |
| Additions | **1,088** | **–** | **–** | **1,088** |
| Disposals / amounts written-off | **(45)** | **–** | **–** | **(45)** |
| Exchange and other movements | **15** | **98** | **–** | **113** |
| At 31 December 2007 | **3,297** | **1,120** | **3** | **4,420** |
| Accumulated amortisation and impairment | | | | |
| At 1 January 2007 | **864** | **58** | **3** | **925** |
| Amortisation charge for the year | **465** | **94** | **–** | **559** |
| Disposals / amounts written-off | **(45)** | **–** | **–** | **(45)** |
| Exchange and other movements | **10** | **7** | **–** | **17** |
| At 31 December 2007 | **1,294** | **159** | **3** | **1,456** |
| Net book value at 31 December 2007 | **2,003** | **961** | **–** | **2,964** |

*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 / amounts written-off | (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 / amounts written-off | (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 |

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 |

# Notes on the Financial Statements (continued)

## 25 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 2007 | **22,537** | **2,947** | **13,022** | **13,493** | **125** | **9,354** |
| Exchange and other adjustments | **(237)** | **(416)** | **158** | **(444)** | **–** | **(78)** |
| Additions | **900** | **–** | **2,297** | **895** | **–** | **1,593** |
| Disposals | **(15)** | **–** | **(677)** | **(14)** | **–** | **(440)** |
| Elimination of accumulated depreciation on revalued premises | **(648)** | **–** | **–** | **(410)** | **–** | **–** |
| Surplus on revaluation | **3,413** | **262** | **–** | **2,243** | **–** | **–** |
| Reclassifications | **(15)** | **15** | **–** | **–** | **–** | **–** |
| At 31 December 2007 | **25,935** | **2,808** | **14,800** | **15,763** | **125** | **10,429** |

| | 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 2007 | **32** | **–** | **9,315** | **29** | **–** | **6,308** |
| Exchange and other adjustments | **(38)** | **–** | **48** | **(32)** | **–** | **30** |
| Charge for the year | **667** | **–** | **1,429** | **423** | **–** | **1,098** |
| Disposals | **(10)** | **–** | **(608)** | **(10)** | **–** | **(414)** |
| Elimination of accumulated depreciation on revalued premises | **(648)** | **–** | **–** | **(410)** | **–** | **–** |
| At 31 December 2007 | **3** | **–** | **10,184** | **–** | **–** | **7,022** |
| Net book value at 31 December 2007 | **25,932** | **2,808** | **4,616** | **15,763** | **125** | **3,407** |
| Total at 31 December 2007 | | | **33,356** | | | **19,295** |

**25 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 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 |

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

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Cost less accumulated depreciation | **12,109** | 11,480 | **8,531** | 8,365 |

# Notes on the Financial Statements (continued)

## 25 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 | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Premises carried at valuation | **25,771** | 22,344 | **15,763** | 13,307 |
| Other premises stated at cost | **164** | 193 | **–** | 186 |
| Premises before deduction of accumulated depreciation | **25,935** | 22,537 | **15,763** | 13,493 |

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| In Hong Kong: | | | | |
| Long leaseholds (over fifty years) | **9,200** | 8,512 | **5,722** | 5,217 |
| Medium-term leaseholds (between ten and fifty years) | **15,151** | 13,650 | **6,746** | 5,301 |
| Short leaseholds (less than ten years) | **121** | 130 | **121** | 125 |
| | **24,472** | 22,292 | **12,589** | 10,643 |
| Outside Hong Kong: | | | | |
| Freeholds | **3,209** | 2,236 | **3,010** | 2,102 |
| Long leaseholds (over fifty years) | **90** | 68 | **60** | 63 |
| Medium-term leaseholds (between ten and fifty years) | **936** | 679 | **196** | 607 |
| Short leaseholds (less than ten years) | **33** | 177 | **33** | 174 |
| | **4,268** | 3,160 | **3,299** | 2,946 |
| | **28,740** | 25,452 | **15,888** | 13,589 |
| Analysed as follows: | | | | |
| Premises | **25,932** | 22,505 | **15,763** | 13,464 |
| Investment properties | **2,808** | 2,947 | **125** | 125 |
| | **28,740** | 25,452 | **15,888** | 13,589 |

The group's premises and investment properties were revalued at 30 September 2007 and updated for any material changes at 31 December 2007. The basis of valuation for premises and investment properties was open market value or depreciated replacement cost as noted in note 4o. 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$7,691 million *(2006: HK$6,274 million)* in respect of properties which were valued using the depreciated replacement cost method.

The surplus on property revaluation was HK$3,675 million *(2006: HK$2,366 million)*. Amounts of HK$2,432 million *(2006: HK$1,356 million)* and HK$384 million *(2006: HK$389 million)* were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$2,432 million *(2006: HK$1,356 million)* is stated after deduction of minority interests of HK$201 million *(2006: HK$238 million)* and deferred tax of HK$658 million *(2006: HK$383 million)*. The amount credited to the income statement comprises the surplus of HK$262 million on revaluation of investment properties and HK$122 million relating to the reversal of previous revaluation deficits that had arisen when the value of certain premises fell below depreciated historical cost.

Premises and investment properties in the Hong Kong SAR, the Macau SAR and mainland China, representing 93% 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 7% by value of the group's properties, were valued by different independent professionally qualified valuers.

## 25 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$151 million *(2006: HK$196 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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Within one year | **104** | 115 | **5** | 4 |
| After one but within five years | **61** | 53 | **–** | 3 |
| | **165** | 168 | **5** | 7 |

## 26 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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| In Hong Kong: | | | | |
| Leases over fifty years | **2,884** | 2,908 | **2,470** | 2,486 |
| Leases of between ten to fifty years | **1,072** | 1,106 | **122** | 125 |
| | **3,956** | 4,014 | **2,592** | 2,611 |

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 27).

## 27 Other assets

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Current taxation recoverable | **1,104** | 604 | **1,060** | 580 |
| Assets held for sale | **473** | 4,976 | **219** | 4,609 |
| Prepayments and accrued income | **6,737** | 5,780 | **4,618** | 5,202 |
| Accrued interest receivable | **16,031** | 12,754 | **9,238** | 8,075 |
| Acceptances and endorsements | **31,918** | 26,729 | **25,801** | 23,443 |
| Other accounts | **13,831** | 9,074 | **8,681** | 4,743 |
| | **70,094** | 59,917 | **49,617** | 46,652 |

In 2007, assets held for sale mainly comprised assets acquired by repossession of collateral for realisation. In 2006, assets held for sale mainly comprised 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 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.

## Notes on the Financial Statements (continued)

### 28 Deposits by banks

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Deposits by banks | **169,177** | 108,125 | **126,604** | 90,787 |
| Fair value | **169,180** | 108,127 | **126,604** | 90,788 |

### 29 Customer accounts

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Current accounts | **417,786** | 292,450 | **280,498** | 219,377 |
| Savings accounts | **983,874** | 785,659 | **699,643** | 562,188 |
| Other deposit accounts | **1,084,446** | 911,358 | **741,859** | 641,954 |
| | **2,486,106** | 1,989,467 | **1,722,000** | 1,423,519 |
| Fair value | **2,486,486** | 1,989,509 | **1,722,268** | 1,423,462 |

### 30 Trading liabilities

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Certificates of deposit in issue | **25,234** | 70,538 | **23,902** | 62,901 |
| Other debt securities in issue | **55,945** | 25,342 | **38,627** | 15,691 |
| Short positions in securities | **59,200** | 49,409 | **33,789** | 28,538 |
| Deposits by banks | **28,799** | 22,023 | **12,344** | 9,634 |
| Customer accounts | **96,497** | 105,233 | **59,637** | 66,106 |
| | **265,675** | 272,545 | **168,299** | 182,870 |

### 31 Financial liabilities designated at fair value

| | Group | | Bank | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Deposits by banks | **728** | 356 | **728** | 356 |
| Customer accounts | **2,638** | 2,482 | **2,638** | 2,482 |
| Subordinated liabilities (note 37) | **989** | 987 | **–** | – |
| Liabilities to customers under investment contracts | **33,792** | 32,729 | **–** | – |
| | **38,147** | 36,554 | **3,366** | 2,838 |

At 31 December 2007 the carrying amount of financial liabilities designated at fair value was HK$6 million lower than the contractual amount at maturity (*2006: HK$38 million*). At 31 December 2007, the accumulated gain in fair value attributable to changes in credit risk was HK$12 million (*2006: HK$nil*).

## 32 Debt securities in issue

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Certificates of deposit | **64,340** | 49,288 | **39,269** | 25,906 |
| Other debt securities | **20,183** | 19,907 | **8,914** | 8,588 |
| | **84,523** | 69,195 | **48,183** | 34,494 |
| Fair value | **84,446** | 69,065 | **48,204** | 34,503 |

## 33 Other liabilities and provisions

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Accruals and deferred income | **23,910** | 16,073 | **17,139** | 12,031 |
| Provisions for liabilities and charges (note 36) | **817** | 984 | **454** | 880 |
| Dividend payable | **–** | 796 | **–** | – |
| Acceptances and endorsements | **31,918** | 26,729 | **25,801** | 23,443 |
| Other liabilities | **13,558** | 11,896 | **9,454** | 8,899 |
| | **70,203** | 56,478 | **52,848** | 45,253 |

## 34 Liabilities under insurance contracts issued

| | | **2007** | |
|---|---|---|---|
| | **Gross** | **Reinsurance** | **Net** |
| | **HK$m** | **HK$m** | **HK$m** |
| **Non-life insurance** | | | |
| Unearned premiums | **962** | **(76)** | **886** |
| Outstanding claims | **1,203** | **(294)** | **909** |
| Claims incurred but not reported | **299** | **(59)** | **240** |
| Provision for unexpired risk | **9** | **–** | **9** |
| Other | **190** | **(1)** | **189** |
| Total non-life | **2,663** | **(430)** | **2,233** |
| **Policyholders' liabilities** | | | |
| Life (non-linked) | **69,461** | **(51)** | **69,410** |
| Investment contracts with discretionary participation features | **226** | **–** | **226** |
| Life (linked) | **19,380** | **(9)** | **19,371** |
| | **89,067** | **(60)** | **89,007** |
| Total liabilities under insurance contracts | **91,730** | **(490)** | **91,240** |

**34 Liabilities under insurance contracts issued** *(continued)*

| | 2006 | | |
|---|---|---|---|
| | Gross HK$m | Reinsurance HK$m | Net 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 |

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 2007 results** | | | Impact on 2006 results | |
|---|---|---|---|---|---|---|
| | *2007 Movement* | *Profit for the year* **HK$m** | *Net assets* **HK$m** | *2006 Movement* | *Profit for the year* HK$m | *Net assets* HK$m |
| **Economic assumption** | | | | | | |
| Exchange rate with USD | **+10%** | **84** | **84** | +10% | (68) | (68) |
| Exchange rate with USD | **-10%** | **(84)** | **(84)** | -10% | 68 | 68 |
| Claims cost inflation | **+20%** | **(79)** | **(79)** | +20% | (53) | (53) |
| Claims cost inflation | **-20%** | **79** | **79** | -20% | 53 | 53 |
| | | | | | | |
| **Non-economic assumption** | | | | | | |
| Mortality and/or morbidity | **+10%** | **(154)** | **(154)** | +10% | (120) | (120) |
| Mortality and/or morbidity | **-10%** | **154** | **154** | -10% | 120 | 120 |
| Lapse rate | **+50%** | **517** | **517** | +50% | 445 | 445 |
| Lapse rate | **-50%** | **(423)** | **(423)** | -50% | (373) | (373) |
| Expense rate | **+10%** | **(96)** | **(96)** | +10% | (67) | (67) |
| Expense rate | **-10%** | **96** | **96** | -10% | 67 | 67 |

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

**34 Liabilities under insurance contracts issued** *(continued)*

**b** *Movement of liabilities under insurance contracts*

*(i) Non-life insurance*

| | **2007** | | |
|---|---|---|---|
| | **Gross HK$m** | **Reinsurance HK$m** | **Net HK$m** |
| **Unearned premiums** | | | |
| At 1 January | **804** | **(92)** | **712** |
| Gross written premiums | **2,373** | **(361)** | **2,012** |
| Gross earned premiums | **(2,243)** | **379** | **(1,864)** |
| Foreign exchange and other movements | **28** | **(2)** | **26** |
| At 31 December | **962** | **(76)** | **886** |
| **Notified and incurred but not reported claims** | | | |
| At 1 January | | | |
| – Notified claims | **1,191** | **(309)** | **882** |
| – Claims incurred but not reported | **283** | **(51)** | **232** |
| | **1,474** | **(360)** | **1,114** |
| Claims paid in current year | **(903)** | **83** | **(820)** |
| Claims incurred | **863** | **(58)** | **805** |
| Foreign exchange and other movements | **68** | **(18)** | **50** |
| At 31 December | | | |
| – Notified claims | **1,203** | **(294)** | **909** |
| – Claims incurred but not reported | **299** | **(59)** | **240** |
| Total at 31 December | **1,502** | **(353)** | **1,149** |

| | 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 |

## Notes on the Financial Statements (continued)

**34 Liabilities under insurance contracts issued** *(continued)*

*(ii) Policyholders' liabilities*

| | **2007** | | |
|---|---|---|---|
| | **Gross HK$m** | **Reinsurance HK$m** | **Net HK$m** |
| **Life (non-linked)** | | | |
| At 1 January | **49,643** | **(19)** | **49,624** |
| Benefits paid | **(1,950)** | **48** | **(1,902)** |
| Claims incurred | **20,854** | **(70)** | **20,784** |
| Foreign exchange and other movements | **914** | **(10)** | **904** |
| At 31 December | **69,461** | **(51)** | **69,410** |
| **Investment contracts with discretionary participation features** | | | |
| At 1 January | **153** | **–** | **153** |
| Benefits paid | **(1)** | **–** | **(1)** |
| Claims incurred | **109** | **–** | **109** |
| Foreign exchange and other movements | **(35)** | **–** | **(35)** |
| At 31 December | **226** | **–** | **226** |
| **Life (linked)** | | | |
| At 1 January | **9,073** | **(1)** | **9,072** |
| Benefits paid | **(3,940)** | **218** | **(3,722)** |
| Claims incurred | **13,950** | **(8,627)** | **5,323** |
| Foreign exchange and other movements | **297** | **8,401** | **8,698** |
| At 31 December | **19,380** | **(9)** | **19,371** |
| Total policyholders' liabilities | **89,067** | **(60)** | **89,007** |

| | 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 |

## 35 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* |
|---|---|---|---|---|---|---|
| **2007** | **HK$m** | **HK$m** | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| At 1 January | **(39)** | **229** | **(991)** | **2,549** | **1,291** | **3,039** |
| Exchange and other adjustments | **173** | **(125)** | **36** | **48** | **(70)** | **62** |
| Charge/(credit) to income statement (note 6) | **1,492** | **(8)** | **(309)** | **(26)** | **(623)** | **526** |
| Charge/(credit) to reserves | **–** | **–** | **–** | **637** | **(682)** | **(45)** |
| At 31 December | **1,626** | **96** | **(1,264)** | **3,208** | **(84)** | **3,582** |
| 2006 | | | | | | |
| 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 6) | (166) | (9) | (187) | (368) | 680 | (50) |
| Charge to reserves | – | – | – | 208 | 530 | 738 |
| At 31 December | (39) | 229 | (991) | 2,549 | 1,291 | 3,039 |

## Notes on the Financial Statements (continued)

**35 Deferred tax** *(continued)*

*Bank*

| | *Accelerated capital allowances and short term timing differences* | *Leasing transactions* | *Impairment losses on financial assets* | *Revaluation of properties* | *Others* | *Total* |
|---|---|---|---|---|---|---|
| **2007** | **HK$m** | **HK$m** | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| At 1 January | **155** | **184** | **(840)** | **1,111** | **316** | **926** |
| Exchange and other adjustments | **134** | **(86)** | **84** | **54** | **(35)** | **151** |
| Charge/(credit) to income statement | **1,442** | **(8)** | **(249)** | **(17)** | **(850)** | **318** |
| Charge/(credit) to reserves | **–** | **–** | **–** | **479** | **(449)** | **30** |
| At 31 December | **1,731** | **90** | **(1,005)** | **1,627** | **(1,018)** | **1,425** |
| 2006 | | | | | | |
| 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 |

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Deferred tax liabilities recognised on the balance sheet | **5,148** | 4,284 | **2,402** | 1,679 |
| Deferred tax assets recognised on the balance sheet | **(1,566)** | (1,245) | **(977)** | (753) |
| | **3,582** | 3,039 | **1,425** | 926 |

There is no significant deferred taxation liability not provided for.

At 31 December 2007, the group has not recognised potential future tax benefits of approximately HK$604 million *(2006 : HK$588 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.

## 36 Provisions for liabilities and charges

*Group*

| | *Provisions for contingent liabilities and commitments* | *Other provisions* | *Total* |
|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** |
| **2007** | | | |
| At 1 January | **855** | **129** | **984** |
| Net (release)/ charge to income statement | **(294)** | **81** | **(213)** |
| Provisions utilised | **(13)** | **(68)** | **(81)** |
| Exchange and other movements | **111** | **16** | **127** |
| At 31 December | **659** | **158** | **817** |
| 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 |

*Bank*

| | *Provisions for contingent liabilities and commitments* | *Other provisions* | *Total* |
|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** |
| **2007** | | | |
| At 1 January | **758** | **122** | **880** |
| Net (release)/ charge to income statement | **(435)** | **61** | **(374)** |
| Provisions utilised | **(13)** | **(55)** | **(68)** |
| Exchange and other movements | **2** | **14** | **16** |
| At 31 December | **312** | **142** | **454** |
| 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 |

## Notes on the Financial Statements (continued)

### 37 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.

| | | 2007 | 2006 |
|---|---|---|---|
| | | **HK$m** | HK$m |
| US$1,200m | Primary capital subordinated undated floating rate notes* | **9,415** | 9,370 |
| Rs 2,000m | Fixed rate (13.05%) subordinated loans 2009 | **396** | 351 |
| *Bank* | | **9,811** | 9,721 |
| A$70m | Subordinated floating rate notes callable quarterly from 2007 to 2012 | – | 425 |
| A$200m | Subordinated floating rate notes callable quarterly from 2011 to 2016 | **1,364** | 1,228 |
| HK$1,500m | Callable floating rate subordinated notes due 2015 | **1,497** | 1,496 |
| US$450m | Callable floating rate subordinated notes due 2016 | **3,496** | 3,483 |
| US$300m | Callable floating rate subordinated notes due 2017 | **2,332** | – |
| *Group* | | **18,500** | 16,353 |
| Fair value | | | |
| – *Bank* | | **8,336** | 9,148 |
| – *Group* | | **16,672** | 15,718 |

* *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 31):

| | | *Group* | |
|---|---|---|---|
| | | **2007** | 2006 |
| | | **HK$m** | HK$m |
| HK$1,000m | Callable fixed rate (4.125%) subordinated notes due 2015 | **989** | 987 |

### 38 Preference shares

*Authorised*

At 31 December 2007, the authorised preference share capital of the Bank was US$12,000,500,000 *(2006: US$ 10,250,500,000)* comprising 2,300,500,000 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 *(2006: 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)*.

## 38 Preference shares *(continued)*

| Issued and fully paid | *Bank and Group* | |
|---|---|---|
| | **2007** | 2006 |
| | **HK$m** | HK$m |
| Redeemable preference shares | **17,940** | 4,281 |
| Irredeemable preference shares | **68,493** | 68,299 |
| Share premium | **3,895** | 3,884 |
| | **90,328** | 76,464 |
| Fair value | **89,069** | 77,163 |

500,000 cumulative redeemable preference shares were issued in 1997, which have a mandatory redemption date of 2 January 2019 but may be redeemed at the Bank's option on or after 2 January 2003, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1,000 per share, comprising nominal value of US$1 per share and premium on issue of US$999 per share. 550,000,000 cumulative redeemable preference shares were issued in 2006, which have a mandatory redemption date of 21 December 2016 but may be redeemed at the Bank's option on or after 21 December 2011, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 1,750,000,000 cumulative redeemable preference shares were issued during the year, which have mandatory redemption dates between 29 March and 24 November 2017 but may be redeemed at the Bank's option on or after dates starting between 29 March and 24 November 2012, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. The total number of issued cumulative redeemable preference shares at 31 December 2007 was 2,300,500,000 *(2006: 550,500,000)*.

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 2007 was 6,653 million *(2006: 6,653 million)*. No shares were issued during the year *(2006: 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 2007 was 2,130 million *(2006: 2,130 million)*. No shares were issued during the year *(2006: nil)*.

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

## 39 Share capital

*Authorised*

The authorised ordinary share capital of the Bank at 31 December 2007 and 2006 was HK$30,000 million divided into 12,000 million ordinary shares of HK$2.50 each. No new shares were issued during 2007.

| Issued and fully paid | *Bank and Group* | |
|---|---|---|
| | **2007** | 2006 |
| | **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.

## Notes on the Financial Statements (continued)

### 40 Reserves

*Group*

| | 2007 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | 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 2007 | 80,942 | 4,798 | 25,812 | (166) | 2,805 | 2,265 | 116,456 | 19,995 | 136,451 |
| Unrealised surplus on revaluation | – | 3,090 | – | – | – | – | 3,090 | 201 | 3,291 |
| Transfer of depreciation | 245 | (245) | – | – | – | – | – | – | – |
| Realisation on disposal of properties | 191 | (191) | – | – | – | – | – | – | – |
| Profit for the year attributable to shareholders | 58,028 | – | – | – | – | – | 58,028 | – | 58,028 |
| Profit for the year attributable to minority interests | – | – | – | – | – | – | – | 7,277 | 7,277 |
| Dividends | (23,000) | – | – | – | – | – | (23,000) | (4,357) | (27,357) |
| Employees' options granted by ultimate holding company | – | – | – | – | – | 285 | 285 | 26 | 311 |
| Actuarial losses on defined benefit plans | (2,998) | – | – | – | – | – | (2,998) | (570) | (3,568) |
| Fair value gains taken to equity | – | – | 33,997 | 488 | – | – | 34,485 | 1,871 | 36,356 |
| Amounts transferred (to)/from the income statement | – | – | (617) | 534 | – | – | (83) | (244) | (327) |
| Transfer to income statement on change in fair value of hedged items | – | – | (513) | – | – | – | (513) | (81) | (594) |
| Share of changes recognised directly in equity of associates | 2 | 147 | (81) | – | – | (54) | 14 | – | 14 |
| Exchange differences | 1,414 | 11 | 20 | (1) | 4,298 | 346 | 6,088 | 204 | 6,292 |
| Deferred tax | 475 | (582) | 261 | (180) | – | – | (26) | 71 | 45 |
| Transfers | (7,441) | (33) | (122) | 2 | 1,795 | 5,799 | – | – | – |
| Other movements | 50 | – | – | – | (11) | (5) | 34 | – | 34 |
| Other increase in minority interest stake | – | – | – | – | – | – | – | 687 | 687 |
| At 31 December 2007 | 107,908 | 6,995 | 58,757 | 677 | 8,887 | 8,636 | 191,860 | 25,080 | 216,940 |

## 40 Reserves *(continued)*

*Bank*

| | 2007 | | | | | | |
|---|---|---|---|---|---|---|---|
| | | *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 2007 | **41,866** | **701** | **23,707** | **(32)** | **1,739** | **808** | **68,789** |
| Unrealised surplus on revaluation | – | **2,172** | – | – | – | – | **2,172** |
| Transfer of depreciation | **135** | **(135)** | – | – | – | – | – |
| Realisation on disposal of properties | **105** | **(105)** | – | – | – | – | – |
| Profit for the year attributable to shareholders | **40,601** | – | – | – | – | – | **40,601** |
| Dividends | **(23,000)** | – | – | – | – | – | **(23,000)** |
| Employees' options granted by ultimate holding company | – | – | – | – | – | **214** | **214** |
| Actuarial losses on defined benefit plans | **(1,906)** | – | – | – | – | – | **(1,906)** |
| Fair value gains taken to equity | – | – | **29,904** | **310** | – | – | **30,214** |
| Amounts transferred (to)/from the income statement | – | – | **(203)** | **371** | – | – | **168** |
| Transfer to income statement on change in fair value of hedged items | – | – | **(368)** | – | – | – | **(368)** |
| Exchange differences | **(22)** | – | **12** | **1** | **2,498** | **13** | **2,502** |
| Deferred tax | **305** | **(479)** | **259** | **(115)** | – | – | **(30)** |
| Transfers | **21** | – | **(16)** | – | **8** | **(13)** | – |
| Other movements | **(9)** | – | **14** | – | – | **(5)** | – |
| At 31 December 2007 | **58,096** | **2,154** | **53,309** | **535** | **4,245** | **1,017** | **119,356** |

## Notes on the Financial Statements (continued)

### 40 Reserves *(continued)*

*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)/from 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 |

## 40 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)/from 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 |

## 40 Reserves *(continued)*

*Regulatory reserve*

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 HKFRS.

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

At 31 December 2007, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$3,803 million (*2006: HK$1,689 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.

## 41 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*

| 2007 | *On demand* | *Due within 1 month* | *Due between 1 and 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$m** | **HK$m** |
| **ASSETS** | | | | | | | | | | |
| Cash and short-term funds | **258,351** | **421,442** | **58,322** | **46,436** | **10,372** | – | – | – | – | **794,923** |
| Items in the course of collection from other banks | – | **20,357** | – | – | – | – | – | – | – | **20,357** |
| Placings with banks maturing after one month | – | – | **46,812** | **9,828** | **3,425** | **263** | – | – | – | **60,328** |
| Certificates of deposit | – | **4,349** | **39,662** | **32,975** | **18,910** | **1,462** | – | – | – | **97,358** |
| Hong Kong SAR Government certificates of indebtedness | **108,344** | – | – | – | – | – | – | – | – | **108,344** |
| Trading assets | – | – | – | – | – | – | – | **360,704** | – | **360,704** |
| Financial assets designated at fair value | – | **9** | **1,201** | **2,231** | **10,366** | **5,798** | **43,547** | – | – | **63,152** |
| Derivatives | – | – | – | – | – | – | – | **173,984** | **6,456** | **180,440** |
| Advances to customers | **111,868** | **128,898** | **134,318** | **203,958** | **330,101** | **310,203** | **(7,260)** | – | – | **1,212,086** |
| Financial investments | – | **34,892** | **46,773** | **82,788** | **236,122** | **49,660** | **82,008** | – | – | **532,243** |
| Amounts due from group companies | – | **209,724** | **24,358** | **5,745** | **1,028** | – | – | **123,869** | – | **364,724** |
| Investments in associates and joint venture | – | – | – | – | – | – | **39,832** | – | – | **39,832** |
| Goodwill and intangible assets | – | – | – | – | – | – | **12,309** | – | – | **12,309** |
| Property, plant and equipment | – | – | – | – | – | – | **33,356** | – | – | **33,356** |
| Deferred tax assets | – | – | – | – | – | – | **1,566** | – | – | **1,566** |
| Retirement benefits | – | – | – | – | – | – | **123** | – | – | **123** |
| Other assets | **4,175** | **20,664** | **23,042** | **9,291** | **3,416** | **398** | **9,108** | – | – | **70,094** |
| **Total assets at 31 December 2007** | **482,738** | **840,335** | **374,488** | **393,252** | **613,740** | **367,784** | **214,589** | **658,557** | **6,456** | **3,951,939** |

## Notes on the Financial Statements (continued)

### 41 Maturity analysis of assets and liabilities *(continued)*

*Group*

| | *On demand* | *Due within 1 month* | *Due between 1 and 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$m** | **HK$m** |
| **LIABILITIES** | | | | | | | | | | |
| Hong Kong SAR currency notes in circulation | **108,344** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **108,344** |
| Items in the course of transmission to other banks | **–** | **31,586** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **31,586** |
| Deposits by banks | **70,962** | **63,524** | **24,434** | **10,224** | **24** | **9** | **–** | **–** | **–** | **169,177** |
| Customer accounts | **1,584,954** | **607,812** | **185,573** | **96,801** | **9,628** | **1,338** | **–** | **–** | **–** | **2,486,106** |
| Trading liabilities | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **265,675** | **–** | **265,675** |
| Financial liabilities designated at fair value | **213** | **895** | **278** | **526** | **1,608** | **1,900** | **32,727** | **–** | **–** | **38,147** |
| Derivatives | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **172,357** | **965** | **173,322** |
| Debt securities in issue | **7** | **8,359** | **25,668** | **37,229** | **7,430** | **5,830** | **–** | **–** | **–** | **84,523** |
| Retirement benefit liabilities | **–** | **–** | **–** | **–** | **–** | **–** | **1,537** | **–** | **–** | **1,537** |
| Amounts due to group companies | **–** | **35,117** | **6,580** | **3,709** | **1** | **2,133** | **–** | **18,306** | **–** | **65,846** |
| Other liabilities | **7,150** | **19,281** | **29,578** | **8,930** | **1,901** | **25** | **3,338** | **–** | **–** | **70,203** |
| Liabilities under insurance contracts issued | **410** | **–** | **–** | **–** | **–** | **–** | **91,320** | **–** | **–** | **91,730** |
| Current tax liabilities | **–** | **642** | **357** | **4,670** | **164** | **–** | **–** | **–** | **–** | **5,833** |
| Deferred tax liabilities | **–** | **–** | **–** | **–** | **–** | **–** | **5,148** | **–** | **–** | **5,148** |
| Subordinated liabilities | **–** | **–** | **–** | **–** | **9,085** | **–** | **9,415** | **–** | **–** | **18,500** |
| Preference shares | **–** | **–** | **–** | **–** | **–** | **21,835** | **68,493** | **–** | **–** | **90,328** |
| **Total liabilities at 31 December 2007** | **1,772,040** | **767,216** | **272,468** | **162,089** | **29,841** | **33,070** | **211,978** | **456,338** | **965** | **3,706,005** |

## 41 Maturity analysis of assets and liabilities *(continued)*

*Bank*

| 2007 | *On demand* | *Due within 1 month* | *Due between 1 and 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$m** | **HK$m** |
| **ASSETS** | | | | | | | | | | |
| Cash and short-term funds | **187,151** | **337,538** | **56,589** | **46,121** | **10,372** | **–** | **–** | **–** | **–** | **637,771** |
| Items in the course of collection from other banks | **–** | **13,946** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **13,946** |
| Placings with banks maturing after one month | **–** | **–** | **29,599** | **7,264** | **2,716** | **263** | **–** | **–** | **–** | **39,842** |
| Certificates of deposit | **–** | **1,060** | **24,701** | **19,816** | **3,211** | **–** | **–** | **–** | **–** | **48,788** |
| Hong Kong SAR Government certificates of indebtedness | **108,344** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **108,344** |
| Trading assets | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **260,107** | **–** | **260,107** |
| Financial assets designated at fair value | **–** | **–** | **76** | **366** | **1,823** | **596** | **–** | **–** | **–** | **2,861** |
| Derivatives | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **173,193** | **4,991** | **178,184** |
| Advances to customers | **74,033** | **95,814** | **86,406** | **117,566** | **193,600** | **181,835** | **(5,724)** | **–** | **–** | **743,530** |
| Financial investments | **–** | **19,584** | **20,109** | **32,468** | **100,903** | **15,959** | **65,202** | **–** | **–** | **254,225** |
| Amounts due from group companies | **–** | **219,332** | **9,012** | **9,832** | **866** | **12,416** | **–** | **129,778** | **–** | **381,236** |
| Investments in subsidiary companies | **–** | **–** | **–** | **–** | **–** | **–** | **16,374** | **–** | **–** | **16,374** |
| Investments in associates and joint venture | **–** | **–** | **–** | **–** | **–** | **–** | **20,461** | **–** | **–** | **20,461** |
| Goodwill and intangible assets | **–** | **–** | **–** | **–** | **–** | **–** | **4,027** | **–** | **–** | **4,027** |
| Property, plant and equipment | **–** | **–** | **–** | **–** | **–** | **–** | **19,295** | **–** | **–** | **19,295** |
| Deferred tax assets | **–** | **–** | **–** | **–** | **–** | **–** | **977** | **–** | **–** | **977** |
| Retirement benefits | **–** | **–** | **–** | **–** | **–** | **–** | **51** | **–** | **–** | **51** |
| Other assets | **3,646** | **11,958** | **17,174** | **6,994** | **2,938** | **355** | **6,552** | **–** | **–** | **49,617** |
| **Total assets at 31 December 2007** | **373,174** | **699,232** | **243,666** | **240,427** | **316,429** | **211,424** | **127,215** | **563,078** | **4,991** | **2,779,636** |

## Notes on the Financial Statements (continued)

### 41 Maturity analysis of assets and liabilities *(continued)*

*Bank*

| | *On demand* | *Due within 1 month* | *Due between 1 and 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** | **HK\$m** |
| **LIABILITIES** | | | | | | | | | | |
| Hong Kong SAR currency notes in circulation | **108,344** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **108,344** |
| Items in the course of transmission to other banks | **–** | **22,837** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **22,837** |
| Deposits by banks | **48,432** | **49,381** | **20,692** | **8,066** | **24** | **9** | **–** | **–** | **–** | **126,604** |
| Customer accounts | **1,124,133** | **395,316** | **126,169** | **67,499** | **7,859** | **1,024** | **–** | **–** | **–** | **1,722,000** |
| Trading liabilities | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **168,299** | **–** | **168,299** |
| Financial liabilities designated at fair value | **–** | **895** | **275** | **520** | **243** | **1,433** | **–** | **–** | **–** | **3,366** |
| Derivatives | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **170,187** | **806** | **170,993** |
| Debt securities in issue | **7** | **6,177** | **19,028** | **21,308** | **1,663** | **–** | **–** | **–** | **–** | **48,183** |
| Retirement benefit liabilities | **–** | **–** | **–** | **–** | **–** | **–** | **875** | **–** | **–** | **875** |
| Amounts due to group companies | **–** | **47,659** | **10,834** | **4,386** | **31** | **2,133** | **–** | **35,923** | **–** | **100,966** |
| Other liabilities | **5,640** | **12,130** | **25,310** | **6,157** | **1,549** | **25** | **2,037** | **–** | **–** | **52,848** |
| Current tax liabilities | **–** | **534** | **352** | **2,390** | **154** | **–** | **–** | **–** | **–** | **3,430** |
| Deferred tax liabilities | **–** | **–** | **–** | **–** | **–** | **–** | **2,402** | **–** | **–** | **2,402** |
| Subordinated liabilities | **–** | **–** | **–** | **–** | **396** | **–** | **9,415** | **–** | **–** | **9,811** |
| Preference shares | **–** | **–** | **–** | **–** | **–** | **21,835** | **68,493** | **–** | **–** | **90,328** |
| **Total liabilities at 31 December 2007** | **1,286,556** | **534,929** | **202,660** | **110,326** | **11,919** | **26,459** | **83,222** | **374,409** | **806** | **2,631,286** |

## 41 Maturity analysis of assets and liabilities *(continued)*

*Group*

| 2006 | *On demand* | *Due within 1 month* | *Due between 1 and 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$m | HK$m |
| **ASSETS** | | | | | | | | | | |
| Cash and short-term funds | 160,649 | 267,529 | 27,465 | 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 | – | 15,353 | 6,669 | 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 | – | 371 | 1,025 | 10,458 | 7,840 | 3,608 | 27,212 | – | – | 50,514 |
| Derivatives | – | – | – | – | – | – | – | 94,747 | 4,420 | 99,167 |
| Advances to customers | 86,988 | 114,090 | 99,299 | 156,306 | 300,390 | 293,552 | (6,843) | – | – | 1,043,782 |
| Financial investments | – | 18,233 | 49,953 | 108,520 | 220,879 | 47,967 | 39,289 | – | – | 484,841 |
| Amounts due from group companies | – | 102,419 | 22,029 | 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 | 27,196 | 10,456 | 9,968 | 1,230 | 185 | 6,864 | – | – | 59,917 |
| Total assets at 31 December 2006 | 354,029 | 591,710 | 294,538 | 390,139 | 563,897 | 350,061 | 135,079 | 466,967 | 4,420 | 3,150,840 |

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

*Group*

| | *On demand* | *Due within 1 month* | *Due between 1 and 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$m | HK$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 | 36,872 | 16,596 | 11,340 | 36 | 85 | – | – | – | 108,125 |
| Customer accounts | 1,258,318 | 493,297 | 152,410 | 74,290 | 8,522 | 2,630 | – | – | – | 1,989,467 |
| Trading liabilities | – | – | – | – | – | – | – | 272,545 | – | 272,545 |
| Financial liabilities designated at fair value | 611 | 716 | 97 | 146 | 1,831 | 1,391 | 31,762 | – | – | 36,554 |
| Derivatives | – | – | – | – | – | – | – | 97,848 | 811 | 98,659 |
| Debt securities in issue | – | 11,585 | 19,047 | 22,225 | 16,260 | 78 | – | – | – | 69,195 |
| Retirement benefit liabilities | – | – | – | – | – | – | 465 | – | – | 465 |
| Amounts due to group companies | – | 12,518 | 2,802 | 2,933 | 11 | 2,125 | – | 10,967 | – | 31,356 |
| Other liabilities | 5,707 | 21,125 | 21,397 | 4,825 | 632 | 38 | 2,754 | – | – | 56,478 |
| Liabilities under insurance contracts issued | – | – | – | – | – | – | 61,350 | – | – | 61,350 |
| Current tax liabilities | 70 | 1,336 | 123 | 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 | 1,410,276 | 634,675 | 212,472 | 119,126 | 33,846 | 14,539 | 178,290 | 381,360 | 811 | 2,985,395 |

## 41 Maturity analysis of assets and liabilities *(continued)*

*Bank*

| 2006 | *On demand* | *Due within 1 month* | *Due between 1 and 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$m | HK$m |
| **ASSETS** | | | | | | | | | | |
| Cash and short-term funds | 130,699 | 205,702 | 27,396 | 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 | – | 8,007 | 4,170 | 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 | 95,005 | 71,490 | 102,854 | 186,190 | 177,518 | (5,702) | – | – | 686,468 |
| Financial investments | – | 12,127 | 37,466 | 60,165 | 83,746 | 15,230 | 34,489 | – | – | 243,223 |
| Amounts due from group companies | – | 103,029 | 12,963 | 3,798 | 1,159 | 10,227 | – | 37,941 | – | 169,117 |
| Investments in subsidiary companies | – | – | – | – | – | – | 7,828 | – | – | 7,828 |
| Investments in associates and joint ventures | – | – | – | – | – | – | 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 | 20,736 | 8,985 | 8,675 | 1,084 | 158 | 3,988 | – | – | 46,652 |
| Total assets at 31 December 2006 | 295,212 | 485,040 | 216,854 | 277,466 | 285,668 | 207,785 | 80,173 | 416,260 | 3,572 | 2,268,030 |

## 41 Maturity analysis of assets and liabilities *(continued)*

*Bank*

| | *On demand* | *Due within 1 month* | *Due between 1 and 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$m | HK$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 | 28,433 | 14,440 | 10,219 | 36 | 85 | – | – | – | 90,787 |
| Customer accounts | 917,075 | 336,876 | 102,125 | 57,808 | 6,960 | 2,675 | – | – | – | 1,423,519 |
| Trading liabilities | – | – | – | – | – | – | – | 182,870 | – | 182,870 |
| Financial liabilities designated at fair value | – | 715 | 97 | 146 | 489 | 1,391 | – | – | – | 2,838 |
| Derivatives | – | – | – | – | – | – | – | 98,598 | 572 | 99,170 |
| Debt securities in issue | – | 8,434 | 10,423 | 11,327 | 4,294 | 16 | – | – | – | 34,494 |
| Retirement benefit liabilities | – | – | – | – | – | – | 447 | – | – | 447 |
| Amounts due to group companies | – | 8,338 | 3,861 | 3,955 | 1,285 | 9,187 | – | 20,975 | – | 47,601 |
| Other liabilities | 4,668 | 14,626 | 19,089 | 4,351 | 479 | – | 2,040 | – | – | 45,253 |
| Current tax liabilities | 66 | 842 | 111 | 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 | 1,061,757 | 448,882 | 150,146 | 89,172 | 13,894 | 21,546 | 81,835 | 302,443 | 572 | 2,170,247 |

## 42 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 2007** | | | | | | |
| Hong Kong SAR currency notes in circulation | **108,344** | – | – | – | – | **108,344** |
| Items in the course of transmission to other banks | **–** | **31,586** | – | – | – | **31,586** |
| Deposits by banks | **70,990** | **88,611** | **10,543** | **30** | **14** | **170,188** |
| Customer accounts | **1,586,588** | **798,116** | **99,507** | **11,155** | **1,453** | **2,496,819** |
| Financial liabilities designated at fair value | **213** | **1,191** | **578** | **1,752** | **34,656** | **38,390** |
| Debt securities in issue | **7** | **34,417** | **39,766** | **9,856** | **10,111** | **94,157** |
| Amounts due to group companies | **–** | **41,724** | **3,798** | **465** | **2,532** | **48,519** |
| Other financial liabilities | **6,368** | **41,740** | **8,784** | **2,610** | **311** | **59,813** |
| Subordinated liabilities | **–** | **292** | **747** | **12,461** | **14,388** | **27,888** |
| Preference shares | **–** | **1,462** | **4,285** | **22,986** | **142,038** | **170,771** |
| | **1,772,510** | **1,039,139** | **168,008** | **61,315** | **205,503** | **3,246,475** |

| | *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 | | | | | | |
| 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 | 43,238 | 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 | 4,970 | 37,703 | 5,705 | 2,343 | 500 | 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 |
| | 1,410,349 | 847,395 | 125,176 | 62,951 | 179,945 | 2,625,816 |

## Notes on the Financial Statements (continued)

**42 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 2007** | | | | | | |
| Hong Kong SAR currency notes in circulation | **108,344** | **–** | **–** | **–** | **–** | **108,344** |
| Items in the course of transmission to other banks | **–** | **22,837** | **–** | **–** | **–** | **22,837** |
| Deposits by banks | **48,437** | **70,617** | **8,319** | **30** | **14** | **127,417** |
| Customer accounts | **1,125,727** | **524,350** | **69,526** | **9,208** | **1,049** | **1,729,860** |
| Financial liabilities designated at fair value | **–** | **1,178** | **541** | **323** | **1,453** | **3,495** |
| Debt securities in issue | **7** | **25,495** | **22,386** | **1,834** | **–** | **49,722** |
| Amounts due to group companies | **–** | **58,520** | **4,475** | **495** | **2,532** | **66,022** |
| Other financial liabilities | **5,330** | **31,513** | **6,094** | **1,825** | **55** | **44,817** |
| Subordinated liabilities | **–** | **171** | **384** | **2,459** | **14,388** | **17,402** |
| Preference shares | **–** | **1,462** | **4,285** | **22,986** | **142,038** | **170,771** |
| | **1,287,845** | **736,143** | **116,010** | **39,160** | **161,529** | **2,340,687** |

| | *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 | | | | | | |
| 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 | 37,614 | 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 | 4,592 | 29,460 | 4,285 | 928 | 94 | 39,359 |
| Subordinated liabilities | – | 176 | 395 | 2,543 | 14,580 | 17,694 |
| Preference shares | – | 1,298 | 3,837 | 20,538 | 126,166 | 151,839 |
| | 1,061,883 | 598,438 | 94,340 | 39,202 | 154,793 | 1,948,656 |

## 42 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$1,186 billion), include cash and short-term funds and items in the course of collection (HK$815 billion); placings with banks maturing after one month (HK$60 billion, including HK$57 billion repayable within one year); and advances to customers (HK$1,212 billion, including HK$579 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.

# Notes on the Financial Statements (continued)

## 43 Reconciliation of operating profit to cash generated from operations

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| **Operating profit** | **74,026** | 49,277 |
| Net interest income | **(62,761)** | (51,099) |
| Dividend income | **(693)** | (749) |
| Depreciation and amortisation | **2,708** | 2,248 |
| Amortisation of prepaid operating lease payments | **59** | 58 |
| Loan impairment charges and other credit risk provisions | **5,805** | 4,809 |
| Advances written off net of recoveries | **(5,293)** | (4,316) |
| Other provisions for liabilities and charges | **(353)** | 93 |
| Provisions utilised | **(81)** | (76) |
| Surplus arising on property revaluation | **(122)** | (70) |
| Gains on investment properties | **(564)** | (475) |
| Profit on disposal of property, plant and equipment and assets held for sale | **(64)** | (981) |
| Profit on disposal of subsidiaries, associates and business portfolios | **(96)** | (904) |
| Gains less losses from dilution of investments in associates | **(4,735)** | – |
| Gains less losses from financial investments | **(892)** | (1,466) |
| Employees' options granted cost free | **311** | 485 |
| Interest received | **115,996** | 95,646 |
| Interest paid | **(73,519)** | (57,763) |
| **Operating profit before changes in working capital** | **49,732** | 34,717 |
| Change in treasury bills with original term to maturity of more than three months | **(16,293)** | (5,063) |
| Change in placings with banks maturing after one month | **46,371** | (34,537) |
| Change in certificates of deposit with original term to maturity of more than three months | **(8,165)** | (15,388) |
| Change in trading assets | **11,027** | (63,574) |
| Change in trading liabilities | **(6,870)** | 22,347 |
| Change in financial assets designated as fair value | **(12,654)** | (13,539) |
| Change in financial liabilities designated as fair value | **1,593** | 3,263 |
| Change in derivatives assets | **(81,112)** | (27,128) |
| Change in derivatives liabilities | **74,584** | 26,651 |
| Change in financial investments held for backing liabilities to long-term policyholders | **(4,332)** | (11,742) |
| Change in advances to customers | **(165,387)** | (60,172) |
| Change in amounts due from group companies | **(196,830)** | (60,055) |
| Change in other assets | **(22,816)** | (26,387) |
| Change in deposits by banks | **57,485** | 24,323 |
| Change in customer accounts | **492,164** | 254,357 |
| Change in amounts due to group companies | **27,386** | 6,247 |
| Change in debt securities in issue | **15,328** | 7,727 |
| Change in liabilities under insurance contracts | **30,380** | 19,505 |
| Change in other liabilities | **(3,628)** | 5,202 |
| Exchange adjustments | **4,368** | 2,188 |
| **Cash generated from operations** | **292,331** | 88,942 |

## 44 Analysis of cash and cash equivalents

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

| | 2007 HK$m | 2006 HK$m |
|---|---|---|
| Balance at 1 January | **510,609** | 444,514 |
| Net cash inflow before the effect of foreign exchange movements | **289,486** | 59,139 |
| Effect of foreign exchange movements | **19,542** | 6,956 |
| Balance at 31 December | **819,637** | 510,609 |

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

| | 2007 HK$m | 2006 HK$m |
|---|---|---|
| Cash in hand and current balances with banks | **76,437** | 48,033 |
| Items in the course of collection from other banks | **20,357** | 46,519 |
| Placings with banks | **588,937** | 372,015 |
| Treasury bills | **135,716** | 88,895 |
| Certificates of deposit | **29,519** | 12,373 |
| Other eligible bills | **257** | – |
| Less: items in the course of transmission to other banks | **(31,586)** | (57,226) |
| | **819,637** | 510,609 |

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

| | 2007 HK$m | 2006 HK$m |
|---|---|---|
| Cash consideration | **(149)** | (22) |
| Cash and cash equivalents acquired | **15** | – |
| | **(134)** | (22) |

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

| | 2007 HK$m | 2006 HK$m |
|---|---|---|
| Sale proceeds | **111** | 441 |
| Cash and cash equivalents transferred | **–** | (32) |
| | **111** | 409 |

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

| | 2007 HK$m | 2006 HK$m |
|---|---|---|
| Sale proceeds | **1,948** | 16,501 |
| Cash and cash equivalents transferred | **–** | – |
| | **1,948** | 16,501 |

# Notes on the Financial Statements (continued)

## 44 Analysis of cash and cash equivalents *(continued)*

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

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Cash consideration | **(780)** | (775) |
| Cash and cash equivalents acquired | **2,779** | – |
| | **1,999** | (775) |

## 45 Contingent liabilities and commitments

**a** *Off-balance sheet contingent liabilities and commitments*

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| **Contingent liabilities and financial guarantee contracts** | | | | |
| Guarantees and irrevocable letters of credit pledged as collateral security | **161,493** | 123,159 | **140,882** | 115,104 |
| Other contingent liabilities | **122** | 35 | **122** | 34 |
| | **161,615** | 123,194 | **141,004** | 115,138 |
| **Commitments** | | | | |
| Documentary credits and short-term trade-related transactions | **54,803** | 34,538 | **45,430** | 27,337 |
| Forward asset purchases and forward forward deposits placed | **461** | 319 | **–** | – |
| Undrawn note issuing and revolving underwriting facilities | **–** | 1,166 | **–** | 1,166 |
| Undrawn formal standby facilities, credit lines and other commitments to lend | | | | |
| – 1 year and under | **1,037,691** | 887,680 | **783,607** | 709,326 |
| – over 1 year | **93,111** | 93,970 | **65,526** | 67,586 |
| | **1,186,066** | 1,017,673 | **894,563** | 805,415 |

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

## 45 Contingent liabilities and commitments *(continued)*

**b** *Guarantees (including financial guarantee contracts)*

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December 2007, were as follows:

| *Group* | **At 31 December 2007** | | At 31 December 2006 | |
|---|---|---|---|---|
| | *Guarantees in favour of third parties* | *Guarantees by the group in favour of other HSBC group entities* | *Guarantees in favour of third parties* | *Guarantees by the group in favour of other HSBC group entities* |
| | **HK$m** | **HK$m** | HK$m | HK$m |
| **Guarantee type** | | | | |
| Financial guarantee contracts[1] | **26,157** | **3,912** | 22,195 | 4,229 |
| Standby letters of credit which are financial guarantee contracts[2] | **25,366** | **28** | 17,734 | 65 |
| Other direct credit substitutes[3] | **30,384** | **21** | 27,778 | 4 |
| Performance bonds[4] | **35,666** | **3,628** | 25,962 | 3,078 |
| Bid bonds[4] | **2,223** | **147** | 1,175 | 132 |
| Standby letters of credit related to particular transactions[4] | **4,942** | **137** | 1,703 | 102 |
| Other transaction-related guarantees[4] | **27,559** | **4,509** | 20,685 | 1,654 |
| | **152,297** | **12,382** | 117,232 | 9,264 |

| *Bank* | **At 31 December 2007** | | At 31 December 2006 | |
|---|---|---|---|---|
| | *Guarantees in favour of third parties* | *Guarantees by the group in favour of other HSBC group entities* | *Guarantees in favour of third parties* | *Guarantees by the group in favour of other HSBC group entities* |
| | **HK$m** | **HK$m** | HK$m | HK$m |
| **Guarantee type** | | | | |
| Financial guarantee contracts[1] | **23,555** | **3,912** | 18,193 | 3,991 |
| Standby letters of credit which are financial guarantee contracts[2] | **22,169** | **28** | 15,343 | 58 |
| Other direct credit substitutes[3] | **27,390** | **21** | 26,016 | 4 |
| Performance bonds[4] | **28,639** | **3,339** | 23,220 | 2,997 |
| Bid bonds[4] | **2,005** | **147** | 1,173 | 132 |
| Standby letters of credit related to particular transactions[4] | **3,925** | **137** | 1,697 | 102 |
| Other transaction-related guarantees[4] | **21,521** | **4,095** | 20,538 | 1,640 |
| | **129,204** | **11,679** | 106,180 | 8,924 |

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

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

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

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

## 45 Contingent liabilities and commitments *(continued)*

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

**c** *Contingencies*

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

## 46 Assets pledged as security for liabilities

Liabilities of the group amounting to HK$64,388 million *(2006: HK$52,244 million)* and of the Bank amounting to HK$28,430 million *(2006: HK$27,554 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$73,594 million *(2006: HK$58,807 million)* and by the Bank is HK$37,802 million *(2006: HK$32,803 million)*. These assets comprise treasury bills, debt securities, equities, and deposits.

In respect of reverse repo and stock borrowing transactions, the fair value of collateral held by the group which were permitted to be sold or repledged amounted to HK$132,945 million *(2006: HK$91,206 million)*, and by the Bank of HK$110,502 million *(2006: HK$83,302 million)*. The fair value of such collateral actually sold or repledged by the group amounted to HK$55,649 million *(2006: HK$40,549 million)* and by the Bank of HK$42,188 million *(2006: HK$32,646 million)*.

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

## 47 Capital commitments

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Expenditure contracted for | **3,053** | 4,459 | **2,267** | 3,333 |
| Expenditure authorised by the Directors but not contracted for | **258** | 116 | **256** | 116 |
| | **3,311** | 4,575 | **2,523** | 3,449 |

The capital commitments mainly relate to the commitment to purchase premises and equipment as well as to continue to invest 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.

## 48 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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Premises | | | | |
| Amounts payable within | | | | |
| – one year or less | **1,804** | 1,494 | **1,046** | 1,016 |
| – five years or less but over one year | **2,685** | 2,374 | **1,464** | 1,413 |
| – over five years | **391** | 180 | **334** | 135 |
| | **4,880** | 4,048 | **2,844** | 2,564 |
| Equipment | | | | |
| Amounts payable within | | | | |
| – one year or less | **75** | 58 | **32** | 33 |
| – five years or less but over one year | **89** | 138 | **50** | 75 |
| – over five years | **–** | – | **–** | – |
| | **164** | 196 | **82** | 108 |

## 49 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:*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **HK$m** | **%** | HK$m | % |
| Hong Kong | **2,549,605** | **64.6** | 2,180,154 | 69.2 |
| Rest of Asia-Pacific | **1,388,786** | **35.1** | 954,567 | 30.3 |
| Americas/Europe | **13,548** | **0.3** | 16,119 | 0.5 |
| Total assets | **3,951,939** | **100.0** | 3,150,840 | 100.0 |

*Total liabilities:*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **HK$m** | % | HK$m | % |
| Hong Kong | **2,418,120** | **65.2** | 2,076,174 | 69.6 |
| Rest of Asia-Pacific | **1,274,563** | **34.4** | 893,304 | 29.9 |
| Americas/Europe | **13,322** | **0.4** | 15,917 | 0.5 |
| Total liabilities | **3,706,005** | **100.0** | 2,985,395 | 100.0 |

## Notes on the Financial Statements (continued)

**49 Segmental analysis** *(continued)*

*Net assets:*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **HK$m** | **%** | HK$m | % |
| Hong Kong | **131,485** | **53.5** | 103,980 | 62.9 |
| Rest of Asia-Pacific | **114,223** | **46.4** | 61,263 | 37.0 |
| Americas/Europe | **226** | **0.1** | 202 | 0.1 |
| | **245,934** | **100.0** | 165,445 | 100.0 |

Minority interests are included in the above table.

*Capital additions during the year:*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **HK$m** | **%** | HK$m | % |
| Hong Kong | **3,403** | **75.3** | 2,543 | 57.7 |
| Rest of Asia-Pacific | **1,115** | **24.7** | 1,863 | 42.3 |
| | **4,518** | **100.0** | 4,406 | 100.0 |

*Investment in associates and joint ventures:*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **HK$m** | **%** | HK$m | % |
| Hong Kong | **1,211** | **3.0** | 992 | 3.9 |
| Rest of Asia-Pacific | **38,621** | **97.0** | 24,542 | 96.1 |
| | **39,832** | **100.0** | 25,534 | 100.0 |

*Credit commitments (contract amounts):*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **HK$m** | **%** | HK$m | % |
| Hong Kong | **715,730** | **53.1** | 655,361 | 57.5 |
| Rest of Asia-Pacific | **631,951** | **46.9** | 484,257 | 42.5 |
| | **1,347,681** | **100.0** | 1,139,618 | 100.0 |

## 49 Segmental analysis *(continued)*

*Consolidated income statement:*

| 2007 | *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 | 91,903 | 51,390 | 860 | – | 144,153 |
| Inter-segment interest income | 4,797 | 2,994 | 219 | (8,010) | – |
| Interest income | 96,700 | 54,384 | 1,079 | (8,010) | 144,153 |
| Interest expense to third parties and fellow subsidiaries | (51,436) | (29,170) | (786) | – | (81,392) |
| Inter-segment interest expense | (3,102) | (4,707) | (209) | 8,018 | – |
| Interest expense | (54,538) | (33,877) | (995) | 8,018 | (81,392) |
| Net interest income | 42,162 | 20,507 | 84 | 8 | 62,761 |
| Fee income | 27,644 | 14,355 | 1 | (851) | 41,149 |
| Fee expense | (3,930) | (3,116) | (13) | 851 | (6,208) |
| Net trading income/(loss) | 7,026 | 9,033 | 1 | (4) | 16,056 |
| Net income/(loss) from financial instruments designated at fair value | 5,322 | 883 | – | (4) | 6,201 |
| Gains less losses from financial investments | 737 | 155 | – | – | 892 |
| Gains arising from dilution of investments in associates | – | 4,735 | – | – | 4,735 |
| Dividend income | 385 | 308 | – | – | 693 |
| Net earned insurance premiums | 21,934 | 1,761 | – | – | 23,695 |
| Other operating income | 6,580 | 597 | 22 | (3,143) | 4,056 |
| **Total operating income** | 107,860 | 49,218 | 95 | (3,143) | 154,030 |
| Net insurance claims incurred and movement in policyholders' liabilities | (25,044) | (1,977) | – | – | (27,021) |
| **Net operating income before loan impairment charges and other credit risk provisions** | 82,816 | 47,241 | 95 | (3,143) | 127,009 |
| Loan impairment charges and other credit risk provisions | (1,799) | (4,006) | – | – | (5,805) |
| **Net operating income** | 81,017 | 43,235 | 95 | (3,143) | 121,204 |
| **Operating expenses** | (27,446) | (22,848) | (27) | 3,143 | (47,178) |
| **Operating profit** | 53,571 | 20,387 | 68 | – | 74,026 |
| Share of profit in associates and joint ventures | 221 | 4,514 | – | – | 4,735 |
| **Profit before tax** | 53,792 | 24,901 | 68 | – | 78,761 |
| Tax expense | (8,826) | (4,623) | (7) | – | (13,456) |
| **Profit for the year** | 44,966 | 20,278 | 61 | – | 65,305 |
| | | | | | |
| Profit attributable to shareholders | 38,605 | 19,362 | 61 | – | 58,028 |
| Profit attributable to minority interests | 6,361 | 916 | – | – | 7,277 |
| | | | | | |
| Net operating income | | | | | |
| – external | 74,569 | 41,766 | (171) | – | 116,164 |
| – inter-company/inter-segment | 6,448 | 1,469 | 266 | (3,143) | 5,040 |
| | | | | | |
| Depreciation and amortisation included in operating expenses | (1,980) | (728) | – | – | (2,708) |

## Notes on the Financial Statements (continued)

**49 Segmental analysis** *(continued)*

| 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/(loss) 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 ventures | 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 | | | | | |
| – external | 58,541 | 28,068 | (135) | – | 86,474 |
| – 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) |

## 49 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. Global 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 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.

## Notes on the Financial Statements (continued)

**49 Segmental analysis** *(continued)*

| 2007 | *Personal Financial Services* HK$m | *Commercial Banking* HK$m | *Global Banking and Markets* HK$m | *Private Banking* HK$m | *Other* HK$m | *Intra-segment elimination* HK$m | *Total* HK$m |
|---|---|---|---|---|---|---|---|
| Net interest income/(expense) | 36,039 | 17,075 | 15,348 | 47 | (4,536) | (1,212) | 62,761 |
| Net fee income | 19,474 | 5,948 | 9,294 | 105 | 120 | – | 34,941 |
| Net trading income | 1,761 | 1,033 | 11,547 | 62 | 950 | 703 | 16,056 |
| Net income/(loss) from financial instruments designated at fair value | 6,966 | (72) | 31 | – | (1,233) | 509 | 6,201 |
| Gains less losses from financial investments | 23 | 1 | 427 | – | 441 | – | 892 |
| Gains arising from dilution of investments in associates | – | – | – | – | 4,735 | – | 4,735 |
| Dividend income | 16 | 6 | 134 | – | 537 | – | 693 |
| Net earned insurance premiums | 22,363 | 1,200 | 132 | – | – | – | 23,695 |
| Other operating income | 1,323 | 249 | 714 | 20 | 7,137 | (5,387) | 4,056 |
| **Total operating income** | 87,965 | 25,440 | 37,627 | 234 | 8,151 | (5,387) | 154,030 |
| Net insurance claims incurred and movement in policyholders' liabilities | (26,217) | (703) | (101) | – | – | – | (27,021) |
| **Net operating income before loan impairment charges and other credit risk provisions** | 61,748 | 24,737 | 37,526 | 234 | 8,151 | (5,387) | 127,009 |
| Loan impairment charges and other credit risk provisions | (4,770) | (784) | (248) | – | (3) | – | (5,805) |
| **Net operating income** | 56,978 | 23,953 | 37,278 | 234 | 8,148 | (5,387) | 121,204 |
| **Operating expenses** | (24,698) | (7,946) | (13,718) | (241) | (5,962) | 5,387 | (47,178) |
| **Operating profit/(loss)** | 32,280 | 16,007 | 23,560 | (7) | 2,186 | – | 74,026 |
| Share of profit in associates and joint ventures | 506 | 2,747 | 1,244 | – | 238 | – | 4,735 |
| **Profit/(loss) before tax** | 32,786 | 18,754 | 24,804 | (7) | 2,424 | – | 78,761 |
| Net operating income | | | | | | | |
| – external | 22,060 | 17,906 | 71,350 | (16) | 4,864 | – | 116,164 |
| – inter-company/inter-segment | 34,918 | 6,047 | (34,072) | 250 | 3,284 | (5,387) | 5,040 |
| Segment assets | 739,365 | 421,495 | 2,650,186 | 4,085 | 468,349 | (371,373) | 3,912,107 |
| Investments in associates and joint ventures | 3,741 | 19,916 | 9,980 | – | 6,195 | – | 39,832 |
| Total assets | 743,106 | 441,411 | 2,660,166 | 4,085 | 474,544 | (371,373) | 3,951,939 |
| Net assets | 45,001 | 36,963 | 74,502 | 200 | 89,268 | – | 245,934 |
| Capital additions during the year | 349 | 97 | 45 | – | 4,027 | – | 4,518 |

## 49 Segmental analysis *(continued)*

| 2006 | *Personal Financial Services* HK$m | *Commercial Banking* HK$m | *Global 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/(expenses) | 10,512 | 5,018 | 6,937 | 101 | (164) | – | 22,404 |
| Net trading income/(loss) | 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 ventures | 257 | 1,634 | 671 | – | 177 | – | 2,739 |
| **Profit/(loss) before tax** | 21,889 | 14,945 | 15,243 | 6 | (67) | – | 52,016 |
| Net operating income | | | | | | | |
| – external | 10,692 | 14,459 | 55,098 | (39) | 6,264 | – | 86,474 |
| – 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 ventures | 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 |

## 50 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 2007, the Bank has issued HK$90,328 million of preference shares to its immediate holding company (*2006: HK$76,464 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 2007, the Bank has issued HK$2,133 million of subordinated liabilities to its ultimate holding company (*2006: HK$2,125 million*). These are classified as liabilities on the balance sheet.

*Income and expenses for the year*

| | *Immediate holding company* | | *Ultimate holding company* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Interest expense[1] | **5,346** | 3,653 | **124** | 115 |
| Other operating income | **–** | – | **19** | 37 |
| Other operating expenses | **71** | 48 | **1,193** | 999 |

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 5b), preference shares issued (note 38).

Interest expense on subordinated liabilities amounted to HK$124 million for the year (*2006: HK$115 million*). Information relating to subordinated liabilities can be found in note 37.

*Balances at 31 December*

*Group*

| | *Immediate holding company* | | *Ultimate holding company* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Amounts due from | **–** | – | **–** | – |
| Amounts due to[1] | **93,054** | 78,992 | **2,775** | 2,489 |

*Bank*

| | *Immediate holding company* | | *Ultimate holding company* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Amounts due from | **–** | – | **–** | – |
| Amounts due to[1] | **93,054** | 78,992 | **2,726** | 2,439 |

1 *Amounts due to the immediate holding company included preference shares of HK$90,328 million (2006: HK$76,464 million). As at 31 December 2007 and 31 December 2006, all preference shares were held by the immediate holding company. Amounts due to the ultimate holding company included subordinated liabilities of HK$2,133 million (2006: HK$2,125 million).*

Guarantees made by the ultimate holding company on behalf of the group amounted to HK$7,029 million *(2006: HK$12,126 million).*

**50 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 51, 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 2007 amounted to HK$1,364 million *(2006: HK$1,082 million)*.

**b** *Subsidiaries and fellow subsidiaries*

In 2007, 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* | |
|---|---|---|
| | **2007** | 2006 |
| | **HK$m** | HK$m |
| Interest income | **8,717** | 4,480 |
| Interest expense[1] | **911** | 1,545 |
| Fee income | **2,276** | 1,237 |
| Fee expense | **1,143** | 680 |
| Other operating income | **1,396** | 1,175 |
| Other operating expenses[2] | **3,527** | 2,988 |

1 *2007 included interest on preference shares of HK$nil (2006: HK$859 million).*
2 *2007 included payment of HK$739million (2006: HK$704 million) of software costs which were capitalised as intangible assets in the balance sheet of the group.*

*Balances at 31 December*

*Group*

| | *Fellow subsidiaries* | |
|---|---|---|
| | **2007** | 2006 |
| | **HK$m** | HK$m |
| Amounts due from | **364,724** | 161,118 |
| Amounts due to | **60,345** | 26,339 |

*Bank*

| | *Subsidiaries* | | *Fellow subsidiaries* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Amounts due from | **43,495** | 28,521 | **337,741** | 140,596 |
| Amounts due to | **40,549** | 20,125 | **54,965** | 22,509 |

## Notes on the Financial Statements (continued)

**50 Related-party transactions** *(continued)*

**c** *Associates and joint ventures*

Information relating to associates and joint venture can be found in note 23 where the following are disclosed:

– investments in associates and joint ventures;

– amounts due from / to associates and joint ventures;

– principal associates.

The group has entered into a Technical Support and Assistance Agreement with Bank of Communications (BoCom), Industrial Bank and Vietnam Technological and Commercial Joint Stock Bank (Techcom) to provide technical support and assistance in relation to their banking business. 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*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Salaries and other short-term benefits | **214** | 163 |
| Post-employment benefits | **13** | 9 |
| Share-based payments | **18** | 51 |
| | **245** | 223 |

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 5p 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:

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Average assets | **24,014** | 22,278 |
| Average liabilities | **18,872** | 12,516 |

The aggregate contribution to the group's profit before tax from such transactions in 2007 was HK$524 million (*2006: HK$503 million*). As at the balance sheet date, guarantees made on behalf of such companies were HK$1,469 million (*2006: HK$3,116 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.

## 50 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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| By the Bank | **172** | 169 | **195** | 209 |
| By subsidiary companies | **–** | – | **1** | 23 |
| | **172** | 169 | **196** | 232 |

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.*

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

**e** *Pension funds*

At 31 December 2007, HK$10.7 billion *(2006: HK$13.0 billion)* of pension fund assets were under management by group companies. Total fees paid or payable by pension plans to group companies for providing fund management, administrative and trustee services amounted to HK$43 million for the year (*2006: HK$38 million*).

## 51 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.

## Notes on the Financial Statements (continued)

**51 Share-based payments** *(continued)*

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

| **2007** | *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] (%) | **5.6** | **5.5** | **5.4** |
| Expected life[2] (years) | **1** | **3** | **5** |
| Expected volatility[3] (%) | **17** | **17** | **17** |

| 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 |

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

***Share Option Schemes***

The share option schemes include The HSBC Holdings 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.

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.

**51 Share-based payments** *(continued)*

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

*Group*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Number* | *Weighted average exercise price* | *Number* | *Weighted average exercise price* |
| | **(000's)** | **£** | (000's) | £ |
| Outstanding at 1 January | **24,421** | **7.84** | 31,908 | 7.79 |
| Exercised in the year | **(919)** | **7.44** | (4,831) | 7.53 |
| Lapsed in the year | **(558)** | **8.18** | (2,656) | 7.79 |
| Outstanding at 31 December | **22,944** | **7.87** | 24,421 | 7.84 |
| Exercisable at 31 December | **22,944** | **7.87** | 16,744 | 7.63 |

*Bank*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Number* | *Weighted average exercise price* | *Number* | *Weighted average exercise price* |
| | **(000's)** | **£** | (000's) | £ |
| Outstanding at 1 January | **18,910** | **7.82** | 24,157 | 7.79 |
| Exercised in the year | **(663)** | **7.47** | (3,395) | 7.52 |
| Lapsed in the year | **(386)** | **8.16** | (1,852) | 7.92 |
| Outstanding at 31 December | **17,861** | **7.87** | 18,910 | 7.82 |
| Exercisable at 31 December | **17,861** | **7.87** | 13,167 | 7.62 |

The options outstanding at the year end had an exercise price in the range of £6.28 to £9.14 (*2006: £5.02 to £8.71*), and a weighted average remaining contractual life of 4.54 years (*2006: 5.51 years*).

The weighted average share price during the year was £9.03 (*2006: £9.59*).

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 £250 per month, with the option to use the savings to acquire shares.

The options are generally exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year savings contracts depending on conditions set at grant. The exercise period of the options awarded may be advanced to an earlier date in certain circumstances, for example on retirement, and may be extended in certain circumstances, for example on the death of a participant the executors may exercise the option up to six months beyond the normal exercise period. There is generally one Sharesave grant each year (in April or May). The exercise price is at a 20 per cent (*2006: 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.

## 51 Share-based payments *(continued)*

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

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

*Group*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Number* | *Weighted average exercise price* | *Number* | *Weighted average exercise price* |
| | **(000's)** | **£** | (000's) | £ |
| Outstanding at 1 January | **19,519** | **6.49** | 28,360 | 6.12 |
| Granted in the year | **2,289** | **7.09** | 1,321 | 7.67 |
| Forfeited/expired in the year | **(1,291)** | **6.73** | (2,052) | 6.26 |
| Exercised in the year | **(5,583)** | **6.51** | (8,110) | 5.44 |
| Outstanding at 31 December | **14,934** | **6.55** | 19,519 | 6.49 |
| Exercisable at 31 December | **104** | **6.56** | 111 | 5.43 |

*Bank*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Number* | *Weighted average exercise price* | *Number* | *Weighted average exercise price* |
| | **(000's)** | **£** | (000's) | £ |
| Outstanding at 1 January | **14,506** | **6.49** | 20,453 | 6.12 |
| Granted in the year | **1,952** | **7.09** | 1,161 | 7.67 |
| Forfeited/expired in the year | **(897)** | **6.82** | (1,435) | 6.25 |
| Exercised in the year | **(3,820)** | **6.52** | (5,673) | 5.45 |
| Outstanding at 31 December | **11,741** | **6.56** | 14,506 | 6.49 |
| Exercisable at 31 December | **86** | **6.57** | 75 | 5.42 |

The options outstanding at the year end had an exercise price in the range of £5.35 to £7.67 (*2006: £5.35 to £7.67*), and a weighted average remaining contractual life of 2.77 years (*2006: 2.15 years*).

The weighted average share price at the date of exercise for share options exercised during the year was £8.96 (*2006: £9.54*).

## 51 Share-based payments *(continued)*

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

*Group*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Number* | *Weighted average exercise price* | *Number* | *Weighted average exercise price* |
| | **(000's)** | **HK$** | (000's) | HK$ |
| Outstanding at 1 January | **6,313** | **103.44** | – | – |
| Granted in the year | **7,702** | **108.45** | 6,378 | 103.44 |
| Forfeited/expired in the year | **(712)** | **105.10** | (65) | 103.44 |
| Exercised in the year | **(1,117)** | **103.44** | – | – |
| Outstanding at 31 December | **12,186** | **106.51** | 6,313 | 103.44 |
| Exercisable at 31 December | **2** | **103.44** | – | – |

*Bank*

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | *Number* | *Weighted average exercise price* | *Number* | *Weighted average exercise price* |
| | **(000's)** | **HK$** | (000's) | HK$ |
| Outstanding at 1 January | **4,322** | **103.44** | – | – |
| Granted in the year | **4,879** | **108.45** | 4,360 | 103.44 |
| Forfeited/expired in the year | **(481)** | **105.00** | (38) | 103.44 |
| Exercised in the year | **(678)** | **103.45** | – | – |
| Outstanding at 31 December | **8,042** | **106.38** | 4,322 | 103.44 |
| Exercisable at 31 December | **2** | **103.44** | – | – |

The options outstanding at the year end had an exercise price in the range of HK$103.44 to HK$108.45 (*2006: HK$103.44*), and a weighted average remaining contractual life of 3.69 years (*2006: 2.99 years*).

The weighted average share price at the date of exercise for share options exercised during the year was HK$140.70 (*2006: nil*).

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

***HSBC Share Plan***

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

## 51 Share-based payments *(continued)*

**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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | *Number* | *Number* | *Number* | *Number* |
| | **(000's)** | (000's) | **(000's)** | (000's) |
| Outstanding at 1 January | **3,092** | 3,003 | **2,530** | 2,473 |
| Additions during the year | **542** | 786 | **517** | 658 |
| Released in the year | **(446)** | (590) | **(360)** | (513) |
| Lapsed in the year | **(758)** | (107) | **(684)** | (88) |
| Outstanding at 31 December | **2,430** | 3,092 | **2,003** | 2,530 |

The weighted average remaining vesting period was 0.75 years (*2006: 1.60 years*).

The weighted average fair value of shares granted during the year with TSR conditions as at the year end was £4.38 (*2006: £4.76*) while shares with EPS conditions had a fair value of £8.42 (*2006: £9.31*) 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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | *Number* | *Number* | *Number* | *Number* |
| | **(000's)** | (000's) | **(000's)** | (000's) |
| Outstanding at 1 January | **5,947** | 5,348 | **5,904** | 5,183 |
| Additions during the year | **3,827** | 3,254 | **3,824** | 3,248 |
| Released in the year | **(2,473)** | (2,340) | **(2,417)** | (2,212) |
| Lapsed in the year | **(784)** | (315) | **(784)** | (315) |
| Outstanding at 31 December | **6,517** | 5,947 | **6,527** | 5,904 |

The weighted average remaining vesting period as at year end was 1.64 years (*2006: 1.61 years*).

The closing price of HSBC Holdings shares on 31 December 2007 was £8.42 (*29 December 2006: £9.31*).

**51 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 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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | *Number* | *Number* | *Number* | *Number* |
| | **(000's)** | (000's) | **(000's)** | (000's) |
| Outstanding at 1 January | **1,549** | 661 | **1,259** | 537 |
| Granted in the year | **2,359** | 933 | **1,962** | 760 |
| Released in the year | **(36)** | (1) | **(22)** | (1) |
| Lapsed in the year | **(187)** | (44) | **(136)** | (37) |
| Outstanding at 31 December | **3,685** | 1,549 | **3,063** | 1,259 |

The weighted average remaining vesting period as at year end was 1.50 years (*2006: 1.83 years*).

***Employee expenses***

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

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Share options granted | **311** | 485 |
| Expense arising from cash-settled share-based payment transactions | **476** | 523 |
| Total expense recognised as employee costs | **787** | 1,008 |
| Total carrying amount of cash-settled transaction liabilities | **875** | 714 |

**52 Risk Management**

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

- credit risk,
- liquidity risk,
- market risk (including foreign exchange, interest rate and equity price risks),
- operational risk, 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.

**52 Risk Management** *(continued)*

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

**a** *Credit risk*

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from lending, trade finance, treasury and leasing business. 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.

**52 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 financial assets

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured with the exception of asset-backed securities and similar instruments, which are secured by pools of financial assets.

The ISDA Master Agreement is the group's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter ('OTC') products is conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement, if either party defaults or following other pre-agreed termination events. It is also common, and the group's preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market contingent counterparty risk inherent in the outstanding positions.

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.

## Notes on the Financial Statements (continued)

**52 Risk Management** *(continued)*

Maximum exposure to credit risk

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

*Group*

| | 2007 HK$m | 2006 HK$m |
|---|---|---|
| Cash and short-term funds | **794,923** | 518,022 |
| Items in the course of collection from other banks | **20,357** | 46,519 |
| Placings with banks maturing after one month | **60,328** | 104,037 |
| Certificates of deposit | **97,358** | 73,200 |
| Hong Kong SAR Government certificates of indebtedness | **108,344** | 102,374 |
| Trading assets | **360,704** | 338,792 |
| Debt securities | **173,067** | 140,252 |
| Equity shares | **33,561** | 23,101 |
| Treasury bills | **108,888** | 152,816 |
| Other | **45,188** | 22,623 |
| Financial assets designated at fair value | **63,152** | 50,514 |
| Debt securities | **19,589** | 22,939 |
| Treasury bills | **–** | – |
| Equity shares | **43,545** | 27,159 |
| Other | **18** | 416 |
| Derivatives | **180,440** | 99,167 |
| Advances to customers | **1,212,086** | 1,043,782 |
| Financial investments | **532,243** | 484,841 |
| Debt securities | **450,235** | 445,260 |
| Equity shares | **82,008** | 39,581 |
| Amounts due from group companies | **364,724** | 161,118 |
| Other assets | **60,002** | 53,150 |
| Acceptances and endorsements | **31,918** | 26,729 |
| Other | **28,084** | 26,421 |
| Financial guarantees and other credit-related contingent liabilities | **115,688** | 100,999 |
| Loan commitments and other credit-related commitments | **1,327,069** | 1,150,033 |
| **At 31 December** | **5,297,418** | 4,326,548 |

Note 17b shows the analysis of advances to customers by industry sector and by geographical region.

**52 Risk Management** *(continued)*

*Bank*

| | **2007** | 2006 |
|---|---|---|
| | **HK$m** | HK$m |
| Cash and short-term funds | **637,771** | 426,176 |
| Items in the course of collection from other banks | **13,946** | 40,434 |
| Placings with banks maturing after one month | **39,842** | 79,249 |
| Certificates of deposit | **48,788** | 33,907 |
| Hong Kong SAR Government certificates of indebtedness | **108,344** | 102,374 |
| Trading assets | **260,107** | 284,057 |
| Debt securities | **106,670** | 103,565 |
| Equity shares | **32,315** | 20,816 |
| Treasury bills | **102,169** | 146,744 |
| Other | **18,953** | 12,932 |
| Financial assets designated at fair value | **2,861** | 11,182 |
| Debt securities | **2,843** | 10,766 |
| Other | **18** | 416 |
| Derivatives | **178,184** | 97,834 |
| Advances to customers | **743,530** | 686,468 |
| Financial investments | **254,225** | 243,223 |
| Debt securities | **189,023** | 208,442 |
| Equity shares | **65,202** | 34,781 |
| Amounts due from group companies | **381,236** | 169,117 |
| Other assets | **41,572** | 42,808 |
| Acceptances and endorsements | **25,801** | 23,443 |
| Other | **15,771** | 19,365 |
| Financial guarantees and other credit-related contingent liabilities | **102,812** | 93,108 |
| Loan commitments and other credit-related commitments | **970,403** | 901,697 |
| **At 31 December** | **3,783,621** | 3,211,634 |

Note 17b shows the analysis of advances to customers by industry sector and by geographical region.

# Notes on the Financial Statements (continued)

**52 Risk Management** *(continued)*

Credit quality

*Distribution of advances by credit quality*

*Group*

| | **At 31 December 2007** | | At 31 December 2006 | |
|---|---|---|---|---|
| | *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 | **1,178,762** | **678,368** | 1,028,909 | 501,163 |
| – past due but not impaired | **32,201** | **174** | 13,115 | 563 |
| – impaired | **8,383** | **–** | 8,601 | – |
| | **1,219,346** | **678,542** | 1,050,625 | 501,726 |

*Bank*

| | **At 31 December 2007** | | At 31 December 2006 | |
|---|---|---|---|---|
| | *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 | **720,806** | **507,720** | 674,068 | 389,633 |
| – past due but not impaired | **21,909** | **174** | 11,274 | 262 |
| – impaired | **6,539** | **–** | 6,828 | – |
| | **749,254** | **507,894** | 692,170 | 389,895 |

## 52 Risk Management *(continued)*

*Distribution of advances neither past due nor impaired*

*Group*

| | **At 31 December 2007** | | At 31 December 2006 | |
|---|---|---|---|---|
| | *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 | **1,151,026** | **675,869** | 993,045 | 499,923 |
| 4 – watch list and special mention | **25,066** | **1,871** | 31,947 | 1,061 |
| 5 – sub-standard but not impaired | **2,670** | **628** | 3,917 | 179 |
| | **1,178,762** | **678,368** | 1,028,909 | 501,163 |

*Bank*

| | **At 31 December 2007** | | At 31 December 2006 | |
|---|---|---|---|---|
| | *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 | **702,152** | **505,221** | 645,262 | 388,423 |
| 4 – watch list and special mention | **16,544** | **1,871** | 25,687 | 1,031 |
| 5 – sub-standard but not impaired | **2,110** | **628** | 3,119 | 179 |
| | **720,806** | **507,720** | 674,068 | 389,633 |

The group's credit risk rating processes are designed to highlight exposures which require closer management attention because of their greater probability of default and potential loss. Risk ratings are reviewed regularly and amendments, where necessary, are implemented promptly.

The credit quality of unimpaired loans is assessed by reference to the group's standard credit rating system.

- 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.

# Notes on the Financial Statements (continued)

**52 Risk Management** *(continued)*

*Debt securities and other bills by rating agency designation*

*Group*

| | At 31 December 2007 | | | |
|---|---|---|---|---|
| | *Treasury bills* | *Other eligible bills* | *Debt securities* | *Total* |
| | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| AAA | **66,715** | **–** | **73,962** | **140,677** |
| AA – to AA + | **118,513** | **257** | **342,896** | **461,666** |
| A – to A + | **73,402** | **240** | **227,252** | **300,894** |
| Lower than A – | **10,972** | **–** | **77,071** | **88,043** |
| Unrated | **2,669** | **–** | **19,068** | **21,737** |
| | **272,271** | **497** | **740,249** | **1,013,017** |

| | At 31 December 2006 | | | |
|---|---|---|---|---|
| | *Treasury bills* | *Other eligible bills* | *Debt securities* | *Total* |
| | HK$m | HK$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 |

*Bank*

| | At 31 December 2007 | | | |
|---|---|---|---|---|
| | *Treasury bills* | *Other eligible bills* | *Debt securities* | *Total* |
| | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| AAA | **66,672** | **–** | **39,578** | **106,250** |
| AA – to AA + | **109,870** | **81** | **169,808** | **279,759** |
| A – to A + | **72,744** | **–** | **69,581** | **142,325** |
| Lower than A – | **10,972** | **–** | **57,829** | **68,801** |
| Unrated | **2,569** | **–** | **10,528** | **13,097** |
| | **262,827** | **81** | **347,324** | **610,232** |

| | At 31 December 2006 | | | |
|---|---|---|---|---|
| | *Treasury bills* | *Other eligible bills* | *Debt securities* | *Total* |
| | HK$m | HK$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 |

**52 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 4d.

Analyses of impairment allowances at 31 December 2007 and the movement of such allowances during the year are disclosed in note 18.

*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* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Residential properties | **208** | 401 | **61** | 198 |
| Commercial and industrial properties | **56** | 14 | **56** | 12 |
| Other assets | **3** | 28 | **–** | 7 |
| | **267** | 443 | **117** | 217 |

Repossessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the balance sheet within 'Other assets' at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance).

**b** *Liquidity risk*

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

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 requirements and limits set by Executive Committee. 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 and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- maintaining debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and

**52 Risk Management** *(continued)*

- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Current accounts and savings deposits payable on demand or at short notice form a significant part of 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 41, while an analysis of possible cash flows under contractual terms is disclosed in note 42.

*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. 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:

| | **2007** | 2006 |
|---|---|---|
| | **%** | % |
| At 31 December | **21.8** | 21.4 |
| Average for the period | **20.5** | 17.6 |
| Maximum for the period | **24.1** | 21.4 |
| Minimum for the period | **16.1** | 14.2 |

**c** *Market risk*

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

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

The management of market risk is principally undertaken in Global Markets through risk limits approved by the group's Executive Committee. Traded Credit and Market Risk, an independent unit within the Global 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.

**52 Risk Management** *(continued)*

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence (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.

# Notes on the Financial Statements (continued)

## 52 Risk Management *(continued)*

The total VAR for Global Markets was as follows:

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **HK$m** | HK$m | **HK$m** | HK$m |
| Total VAR | | | | |
| Year end | **180** | 185 | **157** | 154 |
| Average | **146** | 140 | **120** | 118 |
| Maximum | **213** | 223 | **173** | 178 |
| Minimum | **99** | 64 | **83** | 70 |
| Total interest rate VAR | | | | |
| Year end | **162** | 179 | **137** | 152 |
| Average | **137** | 139 | **110** | 117 |
| Maximum | **209** | 213 | **174** | 170 |
| Minimum | **92** | 64 | **79** | 70 |
| Trading VAR[1] | | | | |
| Year end | **91** | 59 | **88** | 61 |
| Average | **68** | 39 | **73** | 38 |
| Maximum | **124** | 59 | **119** | 61 |
| Minimum | **35** | 26 | **35** | 25 |
| Foreign exchange trading VAR | | | | |
| Year end | **10** | 10 | **13** | 10 |
| Average | **18** | 10 | **13** | 10 |
| Maximum | **40** | 29 | **33** | 32 |
| Minimum | **5** | 4 | **6** | 5 |
| Interest rate trading VAR | | | | |
| Year end | **74** | 43 | **63** | 42 |
| Average | **52** | 35 | **58** | 34 |
| Maximum | **79** | 56 | **87** | 49 |
| Minimum | **28** | 22 | **29** | 22 |
| Equity trading VAR | | | | |
| Year end | **58** | 42 | **58** | 42 |
| Average | **38** | 16 | **38** | 16 |
| Maximum | **100** | 42 | **100** | 42 |
| Minimum | **14** | 4 | **14** | 4 |

1 *The 2006 numbers have been restated to include equity VAR.*

## 52 Risk Management *(continued)*

Non-trading portfolios

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

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

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

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

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

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

Structural foreign exchange exposure

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

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

Foreign currency investments amounted to the foreign currency equivalent of HK$179,330 million (81 per cent of shareholders' funds) at 31 December 2007, an increase of HK$70,865 million from HK$108,465 million (75 per cent of shareholders' funds) at 31 December 2006. 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.

## Notes on the Financial Statements (continued)

**52 Risk Management** *(continued)*

The group had the following structural foreign currency exposures that were not less than 10 per cent of the total net structural exposure in all foreign currencies:

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| **At 31 December 2007** | **LCYm** | **HK$m** | **LCYm** | **HK$m** |
| Chinese renminbi | **98,182** | **104,825** | **53,911** | **57,559** |
| Indian rupees | **94,864** | **18,774** | **66,847** | **13,229** |

| | *Group* | | *Bank* | |
|---|---|---|---|---|
| At 31 December 2006 | LCYm | HK$m | LCYm | HK$m |
| Chinese renminbi | 55,178 | 54,960 | 31,389 | 31,265 |
| United States dollars | 2,043 | 15,886 | 1,523 | 11,842 |
| Indian rupees | 60,248 | 10,585 | 52,426 | 9,211 |

Non-structural positions

The group had the following non-structural foreign currency positions that were not less than 10 per cent of the net non-structural positions in all foreign currencies:

*Group*

| | *United States dollars* | *Singapore dollars* | *Brunei dollars* | *Chinese renminbi* |
|---|---|---|---|---|
| **At 31 December 2007** | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| Spot assets | **2,754,883** | **35,820** | **65,053** | **222,368** |
| Spot liabilities | **(2,700,125)** | **(81,235)** | **(26,586)** | **(201,629)** |
| Forward purchases | **3,584,670** | **258,370** | **58** | **252,162** |
| Forward sales | **(3,653,773)** | **(206,637)** | **(44,713)** | **(274,787)** |
| Net options position | **18,068** | **–** | **–** | **–** |
| | **3,723** | **6,318** | **(6,188)** | **(1,886)** |

| | *United States dollars* | *Singapore dollars* | *Brunei dollars* | *Chinese renminbi* |
|---|---|---|---|---|
| At 31 December 2006 | HK$m | HK$m | HK$m | HK$m |
| Spot assets | 1,205,314 | 118,964 | 27,665 | 78,111 |
| Spot liabilities | (1,222,334) | (140,566) | (107) | (69,689) |
| Forward purchases | 2,222,005 | 168,534 | 24,949 | 97,130 |
| Forward sales | (2,210,290) | (141,505) | (57,857) | (104,949) |
| Net options position | (132) | – | – | – |
| | (5,437) | 5,427 | (5,350) | 603 |

*Bank*

| | *United States dollars* | *Singapore dollars* | *Brunei dollars* | *Chinese renminbi* |
|---|---|---|---|---|
| | **HK$m** | **HK$m** | **HK$m** | **HK$m** |
| **At 31 December 2007** | **(6,226)** | **6,327** | **(6,188)** | **5,173** |
| At 31 December 2006 | (7,297) | 5,429 | (5,350) | 478 |

The net options position reported above are calculated using the delta-weighted position of its options contracts.

## 52 Risk Management *(continued)*

### d *Operational risk*

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

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

**52 Risk Management** *(continued)*

**e** *Insurance risk*

The group underwrites both life and non-life insurance, principally in Hong Kong, Malaysia, Taiwan 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 the carrying amount of the group's insurance liabilities within the financial year is set out in note 34.

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".

**52 Risk Management** *(continued)*

Concentrations of insurance risk

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

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

To determine the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the group.

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 4v, 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 2007 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 24b shows the effect on the PVIF as at 31 December 2007 of reasonably possible changes in the main economic assumptions.

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**f** *Capital management*

The group's objective for managing capital is to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times. The group recognises the impact on shareholder returns of the level of equity capital employed within the group and seeks to maintain a prudent balance between the advantages and flexibility afforded by a strong capital position and the higher returns on equity possible with greater leverage.

## 52 Risk Management *(continued)*

An annual capital plan is prepared by the group's ultimate holding company, HSBC Holdings plc, with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The group follows HSBC Group's policy to hold capital in a range of different forms and from diverse sources and all capital raising is agreed with major subsidiaries as part of their individual and the group's capital management process. The group raises its own non-equity core capital and subordinated debt in accordance with HSBC Group's guidelines regarding market and investor concentration, cost, market conditions, timing and maturity profile.

Each subsidiary manages its own capital within the context of the approved annual Group capital plan, which determines levels of risk-weighted asset growth and the optimal amount and mix of capital required to support planned business growth. As part of the group's capital management policy, capital generated in excess of planned requirements is returned to the Bank, normally by way of dividends.

The Bank is primarily a provider of equity capital to its subsidiaries. These investments are substantially funded by the Bank's own capital issuance and profit retentions. The Bank seeks to maintain a prudent balance between the composition of its capital and that of its investment in subsidiaries.

The principal forms of capital are included in the following balances on the consolidated balance sheet: called-up share capital, share premium account, other reserves, retained earnings, preference shares and subordinated liabilities. Capital also includes the collective impairment allowances held in respect of loans and advances.

Externally imposed capital requirements

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

The Basel Committee on Banking Supervision has published a new capital adequacy framework, known as "Basel II", for calculating minimum capital requirements. With effect from 1 January 2007, the Hong Kong Monetary Authority adopted Basel II as set out in the Banking (Capital) Rules made under the Banking Ordinance. The new Rules, which replace the Third Schedule to the Banking Ordinance, stipulate the calculation methodology for capital adequacy ratio. In 2007, the group is required to use the standardised approach under the Banking (Capital) Rules to calculate its credit risk and operational risk. The group is also required to use a variety of approaches to calculate its market risk, including the internal models approach, the CAD1 model and the standardised approach for different risk categories.

During the year, the individual entities within the group and the group itself complied with all of the externally imposed capital requirements by the Hong Kong Monetary Authority.

## 53 Ultimate holding company

The ultimate holding company of the Bank is HSBC Holdings plc, which is incorporated in England.

The largest group in which the accounts of the Bank are consolidated is that headed by HSBC Holdings plc. The consolidated accounts of HSBC Holdings plc are available to the public on the Group's web site at www.hsbc.com or may be obtained from 8 Canada Square, London E14 5HQ, United Kingdom.

## 54 Nature of business

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

## 55 Accounting standards issued but not yet effective

The HKICPA has issued a number of amendments to HKFRS and Interpretations which are not yet effective for the year ended 31 December 2007 and which have not been adopted in these financial statements.

Hong Kong (IFRIC) Interpretation 11 ‘Group and Treasury Share Transactions’ was issued by the HKICPA in January 2007 and is effective for annual periods beginning on or after 1 March 2007. On application of this interpretation, with effect from 1 January 2008, the group will recognise all share-based payment transactions as equity-settled. At present, certain share-based payment transactions involving principally achievement and restricted share awards are recognised as cash-settled transactions, whereby a liability is recognised in respect of the fair value of such awards at each reporting date. When these are recognised as equity-settled transactions, the fair value of the awards at grant date will be recognised in equity, instead of the fair value being remeasured at each reporting date as a liability. The liability recognised in the accounts of the group at 31 December 2007 in respect of cash-settled share-based payment transactions is HK$875 million (*2006: HK$714million)*.

HKFRS 8 ‘Operating Segments’ (‘HKFRS 8’), which replaces HKAS 14 ‘Segment Reporting’ (‘HKAS 14’), was issued by the HKICPA in March 2007 and is effective for annual periods beginning on or after 1 January 2009. This standard specifies how an entity should report information about its operating segments, based on information about the components of the entity that the chief operating decision maker uses to make operating decisions. The group currently presents two sets of segments in accordance with HKAS 14, one geographical and one based on customer groups, which reflect the way the businesses of the group are managed. The group expects to adopt HKFRS 8 with effect from 1 January 2009 and will accordingly present segmental information which reflects the operating segments used to make operating decisions at that time.

Hong Kong (IFRIC) Interpretation 12 ‘Service Concession Arrangements’ (‘HK(IFRIC)-Int 12’) was issued by the HKICPA in March 2007 and is effective for annual periods beginning on or after 1 January 2008. HK(IFRIC)-Int 12 provides guidance on service concession arrangements by which a government or other public sector entity grants contracts for the supply of public services to private sector operators. HK(IFRIC)-Int 12 addresses how service concession operators should apply existing HKFRSs to account for the obligations they undertake and the rights they receive in service concession arrangements. HK(IFRIC)-Int 12 is unlikely to have a significant effect on the group.

The HKICPA issued a revised HKAS 23 ‘Borrowing Costs’ in June 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised standard eliminates the option of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. The group does not expect the adoption of the revised standard to have a significant effect on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 13 ‘Customer Loyalty Programmes’ (‘HK(IFRIC)-Int 13’) was issued by the HKICPA in September 2007 and is effective for annual periods beginning on or after 1 July 2008. HK(IFRIC)-Int 13 addresses how companies that grant their customers loyalty award credits (often called ‘points’) when buying goods or services should account for their obligation to provide free or discounted goods and services, if and when the customers redeem the points. HK(IFRIC)-Int 13 requires companies to allocate some of the proceeds of the initial sale to the award credits and recognise these proceeds as revenue only when they have fulfilled their obligations to provide goods or services. The group is currently assessing the effect of this interpretation on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 14 ‘HKAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their interaction’ (‘HK(IFRIC)-Int 14’) was issued by the HKICPA in September 2007 and is effective for annual periods beginning on or after 1 January 2008. HK(IFRIC)-Int 14 provides guidance regarding the circumstances under which refunds and future reductions in contributions from a defined benefit plan can be regarded as available to an entity for the purpose of recognising a net defined benefit asset. The group is currently assessing the effect of this interpretation on the consolidated financial statements.

The HKICPA issued a revised HKAS 1 ‘Presentation of Financial Statements’ in December 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised standard aims to improve users’ ability to analyse and compare information given in financial statements. Adoption of the revised standard will have no effect on the results reported in the group’s financial statements, other than a change in presentation in certain respects.

## 56 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 3 March 2008.

# 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 24 to 172, which comprise the consolidated and the Bank's balance sheets as at 31 December 2007, 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 2007 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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3 March 2008

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