2008

The Hongkong and Shanghai Banking Corporation Limited Annual Report and Accounts

HSBC

The world's local bank

Annual Report and Accounts 2008

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

	2008	2007
For the year	**HK$m**	HK$m
Net operating income before loan impairment charges	**124,264**	127,009
Profit before tax	**67,690**	78,761
Profit attributable to shareholders	**50,306**	58,028
At year-end		
Shareholders' equity	**193,612**	220,854
Total equity	**216,486**	245,934
Total capital base	**190,598**	206,449
Customer accounts	**2,576,084**	2,486,106
Total assets	**4,260,356**	3,951,939
Ratios	**%**	%
Return on average shareholders' equity	**24.3**	32.1
Post-tax return on average total assets	**1.31**	1.78
Cost efficiency ratio	**42.1**	37.1
Net interest margin	**2.36**	2.37
Capital adequacy ratios		
– capital adequacy	**13.4**	11.6
– core capital	**10.3**	8.8

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 910 branches and offices in 19 countries and territories in Asia-Pacific – the largest network of any international financial institution in the region – and some 20 branches and offices in six other countries around the world. Employing some 65,500 people, of whom 43,700 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2008 of HK$4,260 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 around 9,500 offices in 86 countries and territories and assets of US$2,527 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*
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
Andreas Sohmen-Pao *(appointed on 1 May 2008)*
T Brian Stevenson, SBS
Dr Patrick Wang Shui Chung
David Wei Zhe
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 23 to 202.

Reserves

Profits attributable to shareholders, before dividends, of HK$50,306 million have been transferred to reserves. During the year, a surplus of HK$1,543 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$400 million (HK$3,113 million) by the issue of 400 million Cumulative Redeemable Preference Shares of US$1.00 each. The shares were issued in order to finance the acquisition of an interest in The Chinese Bank Co., Limited 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.

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 and The HSBC Share Plan. During the year, V H C Cheng, A A Flockhart, M F Geoghegan, S K Green, S T Gulliver and R C F Or acquired shares in HSBC Holdings plc under the terms of The HSBC Share Plan. V H C Cheng and A A Flockhart also acquired shares by exercising options.

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

Executive Committee

An Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board. The current members of the Committee are A A Flockhart (Chairman of the Committee), Peter Wong Tung Shun (Director), E D Ancona (Chief Financial Officer), R H Cox (Chief Risk Officer), C Engel (Regional Director, Personal Financial Services), N P Fretwell (Head of Human Resources), D L Fried (Group General Manager, Regional Head of Insurance), Anita Fung Yuen Mei (Group General Manager, Head of Global Markets), P E Leech (Head of International), Margaret Leung Ko May Yee (General Manager, Global Co-Head Commercial Banking), E I Sinyak (Chief Technology and Services Officer) and F Slevin (Head of Global Banking).

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$70 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, which will be published separately, for the year ended 31 December 2008 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, 2 March 2009

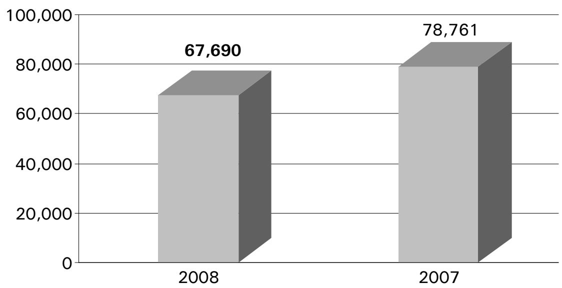
Financial Review

Summary of Financial Performance

Group Profit

Profit attributable to shareholders for 2008 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiary and associated companies ('the group') decreased by HK$7,722 million, or 13.3 per cent, to HK$50,306 million in 2008. Profit before taxation decreased by HK$11,071 million, or 14.1 per cent, to HK$67,690 million.

Profit before tax (HK$ millions)



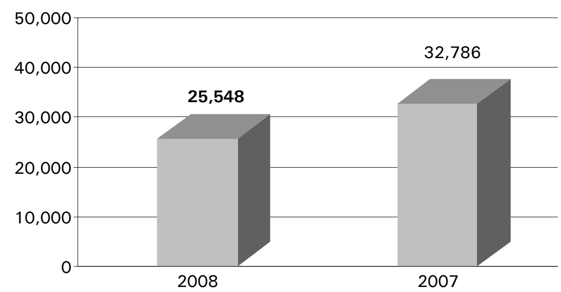
Customer Groups

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$25,548 million, a decrease of 22.1 per cent from 2007. The reduction was primarily a result of the fall in the equity markets during the year, affecting insurance manufacturing asset values and the sale of investment products.

Personal Financial Services

Profit before tax (HK$ millions)



Net interest income increased by HK$1,663 million, or 4.6 per cent, compared with 2007. In Hong Kong, the rise in net interest income was driven by growth in deposit balances, but this was partially offset by lower asset spreads, particularly in mortgage lending. Following the US interest rate cuts and the various monetary measures taken in the last two months of 2008, asset margins improved given the lower cost of funds. However, this was offset by compressed deposit margins.

In Hong Kong, lending volumes increased, due in part to a 12.0 per cent rise in new mortgage lending as a result of effective pricing promotions and tactical sales incentive programs. Card lending also rose as cardholder spending remained strong. Nearly one million new cards were issued in the period, bringing the total number of cards in circulation in Hong Kong to 5.3 million.

In the Rest of Asia-Pacific, net interest income increased by HK$1,387 million, or 10.4 per cent, driven by higher asset spreads in India, Singapore and Australia, and robust growth in advances in Australia, mainland China and Singapore. With the continued focus on Premier, the deposit portfolio grew strongly, which helped to partly offset the effects of compressed deposit margins.

Net fee income decreased by HK$4,157 million, or 21.3 per cent, compared with 2007 largely due to reduced demand for investment-related products as a result of negative market sentiment, particularly in Hong Kong. This fall was partly offset by an increase in fee income from credit cards. The group maintained its leadership position in credit cards in Hong Kong and continued to drive innovation in the business with the launch of the 'Green Credit Card' in March, a new proposition in which a percentage of spending on the card is directed to a group environmental programme.

In the Rest of Asia-Pacific, net fee income remained broadly unchanged, with strong growth in India, Australia, Indonesia, the Philippines and Singapore offset by falls in income in South Korea, Taiwan and mainland China. Higher fees from credit cards helped offset lower investment income. While the number of cards in circulation decreased marginally, mainly in India, cardholder spending per active card increased by nine per cent year-on-year.

Gains less losses from financial investments included a gain of HK$1,245 million on the sale of MasterCard and Visa shares.

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') decreased by 41 per cent compared with 2007. Insurance premiums increased by 12 per cent due to growth in new product sales through direct channels, including internet banking and telemarketing. However, the increase in premiums was offset by the poor performance of global equities markets, which affected both net income from financial instruments designated at fair value and the movement in policyholders' liabilities.

The charges for loan impairment increased by HK$855 million to HK$5,625 million, mainly as a result of the difficult collections environment in India and deteriorating economic conditions in 2008. India, Australia, the Philippines and Indonesia recorded higher charges. These increases were partly offset by the improvement in asset quality and increased collections effectiveness in Taiwan compared to 2007.

As the financial crisis deepened in the US and Europe in the second half of 2008, Asia started to show signs of the slowdown. The group tightened criteria for new customer advances early in the year in anticipation of the slowdown and focussed on lower-risk segments by cross-selling to existing customers and partnership arrangements.

Operating expenses were HK$2,544 million, or 10.3 per cent higher than 2007. In Hong Kong, operating expenses rose by 4 per cent, driven by salary adjustments, increased headcount compared with the end of 2007 (although lower than at June 2008) and increased premises costs in part due to branch refurbishment.

In the Rest of Asia-Pacific, costs increased by HK$2,059 million, or 17 per cent. Significant investment in the region continued, especially in mainland China with the opening of 18 HSBC-branded outlets and two rural banks and in Japan with the rollout of seven HSBC Premier Centres. The group also continued to invest in Taiwan, Australia, India, Indonesia and Vietnam to support organic business expansion and the integration of strategic investments in both retail banking and insurance.

Income from associates of HK$968 million included results from Bank of Communications and Industrial Bank.

Commercial Banking reported profit before tax of HK$19,159 million, an increase of 2.2 per cent over 2007. Increased impairment charges and lower interest rates impacted the results. Net operating income before loan impairment charges increased 11.8 per cent, driven by continued strong balance sheet growth and increasing cross-border alignment.

Net interest income increased by HK$883 million, or 5.2 per cent, compared with 2007 due to growth in deposits and advances.

In Hong Kong, net interest income fell by HK$316 million, or 2.6 per cent, as margins compressed. Despite Hong Kong dollar interest rates falling, Hong Kong dollar and foreign currency deposit balances increased due to a series of account acquisition campaigns, tactical campaigns for savings accounts and time deposits, expectations of foreign currency appreciation and the launch of the new Business Direct account.

Financial Review (continued)

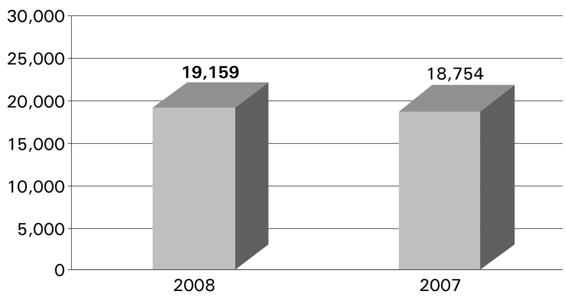
Customer Groups *(continued)*

Customer lending in Hong Kong increased 14.0 per cent to HK$245 billion. Strong growth was recorded in the first half of the year given the stable economic environment in early 2008. The group's lending to its 280,000 small and medium enterprise customers increased over the 2007 level as the group maintained its commitment to the SME Loan Guarantee Scheme which was first launched by the Hong Kong Government in 2001.

In the Rest of Asia-Pacific, net interest income grew by 23.5 per cent, or HK$1,199 million, due to growth in deposit and lending balances, particularly in mainland China and India.

Commercial Banking

Profit before tax (HK$ millions)



Deposit balances benefited in part from customers' preference for liquidity following declines in equity markets. Our 'Best Bank for Small Business' strategy also led to income growth. Customer numbers and deposits also increased following the launch of Business Direct in India.

Net fee income increased by HK$842 million, or 14.2 per cent over 2007, driven by trade services growth in India and mainland China, foreign exchange volatility and account transaction and remittance service fees.

In Hong Kong, net fee income rose by 4.2 per cent as fees from trade services rose, benefiting from higher commodity prices in the first half of the year and higher value per transaction.

In the Rest of Asia-Pacific, net fee income increased by 36.2 per cent driven by increased trade service fee income in India and mainland China.

Net trading income increased by HK$370 million compared with 2007 as foreign exchange income benefited from increased currency volatility and the increased trading volume between the US dollar and Hong Kong dollar.

Financial investments benefited from the sale of MasterCard and Visa shares, with a net gain of HK$262 million recorded.

The net charge for loan impairments was HK$2,846 million higher than in 2007, mainly as a result of higher individual charges against corporate customers in Hong Kong. The deterioration was attributable to a number of factors including exporters in Hong Kong being affected by reduced demand from the US and other developed countries. The sharp fall in the value of currencies and commodities left some customers' balance sheets weakened, coupled with rising fraud encountered with certain counterparties. In addition, significant recoveries that were recognised in 2007 did not recur in 2008.

Outside Hong Kong, loan impairment charges increased by HK$463 million against 2007. However, a number of countries, such as Mauritius, Thailand and Australia made net recoveries despite the current environment.

Operating expenses increased by 16.2 per cent, or HK$1,285 million over 2007, largely due to increased staff costs in India and mainland China as investment in the business continued. Investment was undertaken to expand the group's presence, notably in mainland China and also in Taiwan where the branch network grew from eight at end of 2007 to 33 at the end of 2008, following the integration of the operations of The Chinese Bank. IT and infrastructure costs were also higher throughout the region as a result of branch expansion.

Income from associates of HK$4,367 million included the group's share of profits of Bank of Communications and Industrial Bank.

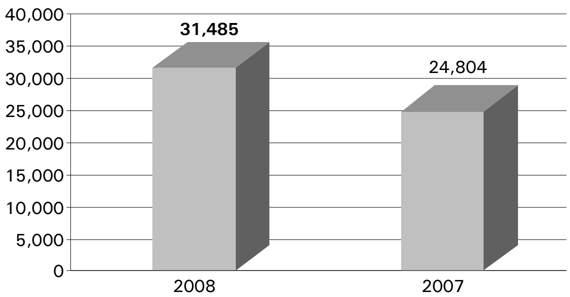
Global Banking and Markets reported profit before tax of HK$31,485 million, 26.9 per cent higher than 2007, largely due to higher net interest income from balance sheet management and higher net trading income from foreign exchange and Rates business.

Customer Groups *(continued)*

Net interest income increased by HK$7,727 million, or 50.3 per cent, compared with 2007. Balance Sheet Management revenues increased as the business benefited from earlier positioning for falling short-term interest rates across the region and in the US. Interest rate cuts in the US in response to the liquidity strain in the interbank market totalled 400 basis points over the 12 months to December. In mainland China, strong growth in the balance sheet, improved spreads and interest rate positioning led to higher revenues as the business continued to see the benefits of local incorporation in March 2007. Securities services contributed to the increase in net interest income as a result of a rise in deposits accompanied by improved spreads across the region. Global Banking lending revenues also grew, supported by higher loan balances and improved spreads in Hong Kong.

Global Banking and Markets

Profit before tax (HK$ millions)



Net fee income decreased by 10.5 per cent compared with 2007 as a result of fewer opportunities for IPOs, debt underwriting deals and loan syndication transactions. Nevertheless, the group continued to lead the Asian debt issuance league tables. However, securities services remained strong, led by the sub-custody and clearing business which performed strongly despite the adverse impact of the financial markets downturn.

Net trading income increased by HK$2,820 million, or 24.4 per cent, compared with 2007. In Hong Kong trading income was HK$1,082 million lower driven by write-downs in Global Banking and Markets. The write-downs were due in part to an exposure to a monoline insurer. Setting this aside, foreign exchange and Rates income grew strongly as continuing market volatility drove increased customer demand and trading opportunities.

In the Rest of Asia-Pacific, trading income rose strongly by HK$3,902 million, or 69.7 per cent, as volumes in foreign exchange and Rates products increased with higher customer demand and trading activity. This was driven by volatility in both the currency and Rates markets. The group's extensive presence across the region and its continued focus on emerging markets meant it was well-positioned to capture these sales and trading opportunities. Growth in South Korea was attributable to strong Rates performance, driven by increased activity in the local Rates market and hedging related to financing activity. Similarly in Australia, income growth from Rates was due to strategic positioning of the balance sheet to benefit from interest rate cuts in 2008. In mainland China, revenues increased significantly on account of Rates trading activity as a result of the tightening in US dollar spreads and movements in local currency government bond rates. Foreign exchange trading and sales revenues also showed good growth over 2007.

Loan impairment charges increased by HK$2,506 million over 2007 as a result of a number of significant write-downs on individual available-for-sale debt holdings.

Operating expenses increased by HK$519 million, or 3.8 per cent. Higher staff costs reflected increased headcount in the first half compared with 2007, although there were various cost-saving initiatives in the second half as financial and economic conditions deteriorated. Investment in IT and infrastructure rose as transaction volumes increased and the expansion into emerging markets continued.

Profit from associates and joint ventures increased by HK$969 million reflecting an increase in the share of profits from Bank of Communications and Industrial Bank.

Other included income and expenses relating to certain funding, investment, property and other activities that are not allocated to the customer groups.

In 2008 there was a significant fall in the market price, compared to cost, of long-term strategic equity investments held by the group. In accordance with accounting standards, this resulted in a write-down of HK$3,294 million recognised in the income statement.

The dilution gains recognised in 2007 on the group's interests in Bank of Communications and Industrial Bank were not repeated in 2008.

Financial Review (continued)

Customer Groups *(continued)*

(HK$ millions)

	Personal Financial Services	Commercial Banking	Global Banking and Markets	Private Banking	Other	Intra-segment elimination	Total
2008							
Net interest income/(expense)	**37,702**	**17,958**	**23,075**	**43**	**(5,497)**	**(4,236)**	**69,045**
Net fee income	**15,317**	**6,790**	**8,319**	**83**	**258**	**–**	**30,767**
Net trading income	**1,570**	**1,403**	**14,367**	**165**	**(302)**	**4,160**	**21,363**
Net (loss)/ income from financial instruments designated at fair value	**(11,394)**	**(77)**	**266**	**–**	**147**	**76**	**(10,982)**
Gains less losses from financial investments	**1,228**	**250**	**(571)**	**–**	**(3,883)**	**–**	**(2,976)**
Dividend income	**27**	**17**	**173**	**–**	**635**	**–**	**852**
Net earned insurance premiums	**25,061**	**1,649**	**159**	**–**	**17**	**–**	**26,886**
Other operating income	**1,406**	**841**	**582**	**22**	**7,392**	**(6,167)**	**4,076**
Total operating income	**70,917**	**28,831**	**46,370**	**313**	**(1,233)**	**(6,167)**	**139,031**
Net insurance claims incurred and movement in policyholders' liabilities	**(13,470)**	**(1,178)**	**(107)**	**–**	**(12)**	**–**	**(14,767)**
Net operating income before loan impairment charges and other credit risk provisions	**57,447**	**27,653**	**46,263**	**313**	**(1,245)**	**(6,167)**	**124,264**
Loan impairment charges and other credit risk provisions	**(5,625)**	**(3,630)**	**(2,754)**	**–**	**9**	**–**	**(12,000)**
Net operating income	**51,822**	**24,023**	**43,509**	**313**	**(1,236)**	**(6,167)**	**112,264**
Operating expenses	**(27,242)**	**(9,231)**	**(14,237)**	**(326)**	**(7,394)**	**6,167**	**(52,263)**
Operating profit/(loss)	**24,580**	**14,792**	**29,272**	**(13)**	**(8,630)**	**–**	**60,001**
Share of profit in associates and joint venture	**968**	**4,367**	**2,213**	**–**	**141**	**–**	**7,689**
Profit/(loss) before tax	**25,548**	**19,159**	**31,485**	**(13)**	**(8,489)**	**–**	**67,690**

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	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)

Net Interest Income

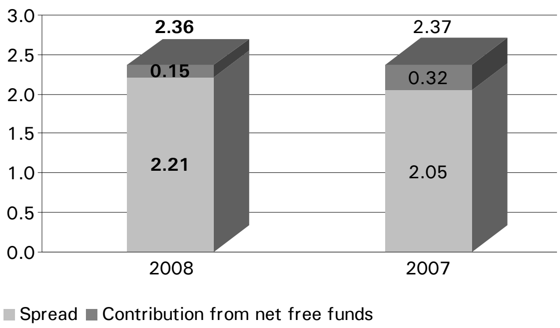
Net interest income increased by HK$6,284 million, or 10.0 per cent, to HK$69,045 million. Higher net interest income was driven by a combination of asset growth and lower costs of funds. Changes to balance sheet management also led to a reduced yield, where funds have been deployed into high quality but lower-yielding assets to reduce risk. Net interest income has also been impacted by the redeployment of commercial surplus to support trading activities, where returns are reported in 'Net trading income'.

Average interest-earning assets grew by HK$277.2 billion to HK$2,926.3 billion (10.5 per cent), with the increase predominantly in the first half of 2008. Average advances to customers increased by HK$164.3 billion (14.0 per cent) to HK$1,306.7 billion, largely driven by volume growth in term lending in Hong Kong and mainland China, coupled with higher demand for mortgages. Indonesia, India, South Korea and Singapore also reported higher average corporate lending. Average loans to banks increased by HK$67.1 billion to HK$756.2 billion funded by the redeployment of commercial surplus across the region, particularly in central bank loans and reverse repos. Furthermore, surplus funds have been re-deployed to government-sponsored securities and loans to fellow Group entities in recent months. As a result, inter-company interest-bearing assets increased HK$58.4 billion to HK$202.4 billion, offset by lower average financial investments, down HK$12.1 billion to HK$665.7 billion.

(HK$ millions)	2008	2007
Average interest-earning assets	**2,926,332**	2,649,116

Net interest margin was 2.36 per cent, one basis point lower than 2007. Net interest spread improved by 16 basis points to 2.21 per cent, offset by a decline of 17 basis points for the contribution from net free funds, partly owing to growth in the trading book. Despite a widened interest spread compared to 2007, it gradually narrowed during 2008 against the backdrop of falling interest rates. Higher net interest spreads and margins in Hong Kong were offset by the Rest of Asia-Pacific.

Net interest margin (%)



For the bank in Hong Kong, net interest margin remained unchanged at 2.27 per cent as at 31 December 2008. Interest spread was 16 basis points higher at 2.29 per cent, benefiting from the combined effect of greater savings in cost of funds and volume growth in savings and lending portfolios. Growth in customer deposits and term lending were driven by increased number of transactions in both Hong Kong and mainland China. Ongoing pricing and promotion programmes were major drivers for higher mortgages and credit card advances. Increases to inter-company interest-earning loans with fellow Group companies, including Structured Investment Vehicles ('SIVs',) also led to a higher margin. Improvement in balance sheet management income from re-pricing of portfolios reflected the delayed effect of lower interest rates on the back of successive US interest rate cuts. The easing of inter-bank rates in the second half of 2008 had a direct impact on Best Lending Rates. At the same time, contribution from net free funds was 16 basis points lower as a result of more funds being used to acquire debt securities and treasury bills under the trading portfolio.

At Hang Seng Bank, net interest margin improved by five basis points to 2.59 per cent. Net interest spread increased by 36 basis points to 2.34 per cent. An improved spread was the result of growing personal and commercial business, lower costs of customer deposits and timing of mortgage re-pricing. Volume growth was noted in mortgages, higher-yielding personal loans, credit cards, mainland China loans and trade finance facilities. Growth in money market placements and a reduction in debt securities reflected a change in asset mix in light of the difficult market conditions. Meanwhile, the benefit of interest-free funds decreased by 31 basis points to 0.25 per cent, reflecting funding of a larger trading portfolio.

Net interest margin (%)

	2008	2007
Hong Kong:		
The bank	**2.27**	2.27
Hang Seng Bank	**2.59**	2.54
Rest of Asia-Pacific	**2.09**	2.25

Net Interest Income *(continued)*

In the Rest of Asia-Pacific, net interest margin was 2.09 per cent as at 31 December 2008, 16 basis points lower than 2007. Meanwhile, interest spread reduced by 28 basis points to 1.78 per cent. The narrowing spread was driven by the combination of falling interest rates and redeployment of commercial surplus to lower-yielding inter-bank placements and trading activities to manage liquidity. The lower spread particularly affected mainland China, with balance sheet growth in the region largely consistent with ongoing branch expansions, particularly in customer accounts and personal lending. With deposits growing at a faster rate than loans and advances, excess funds have been utilised to invest in bonds at lower yields. Singapore also reported a lower margin on the back of falling inter-bank rates. However, Australia, South Korea and Japan all reported higher margins through growth in customer lending and deposits. In India, a higher margin was the result of greater emphasis on commercial lending and core deposit products. At the same time, the region progressively reduced exposures to unsecured personal lending because of the deteriorating credit environment.

Net Fee Income

Net fee income was HK$4,174 million, or 11.9 per cent, lower than in 2007.

Unit trusts income reduced by 49.6 per cent, as the demand for wealth management products decreased substantially in 2008. Volatility in global equity markets and an unfavourable investment climate led to a decline in new sales of unit trusts and investment funds in Hong Kong. As a result, subscription fees and commissions fell. The adverse conditions also had a negative impact on South Korea, Taiwan and Singapore.

Securities and stockbroking income decreased by 18.0 per cent, in contrast to a high performing year in 2007. With a lower stock market turnover, income generated from stockbroking activities, IPO opportunities and custodian services reduced, notably in Hong Kong and South Korea.

Card fees were 22.8 per cent higher than 2007 which was largely in line with growth in average credit card advances and outstanding balances. An increase in circulation also resulted in rising merchant and interchange fee income. Favourable performance was noted in Hong Kong, Australia, India, Indonesia, Philippines and Singapore. Fee income also included those generated from the acquisition of the assets, liabilities and operations of The Chinese Bank in Taiwan.

Underwriting income, which is included within 'Other', decreased significantly, due to fewer large deals concluded in 2008 in Hong Kong. At the same time, remittances increased by 14.9 per cent due to volume growth in trade between mainland China and Hong Kong. The growing customer base as a result of the extensive branch expansions in mainland China was also a factor. Singapore benefited from marketing campaigns aiming to enhance the awareness of international remittance services.

(HK$ millions)	2008	2007
Account services	**2,027**	1,625
Credit facilities	**1,767**	1,471
Import/export	**3,970**	3,360
Remittances	**1,900**	1,653
Securities/stockbroking	**9,734**	11,874
Cards	**5,308**	4,321
Insurance	**617**	889
Unit trusts	**2,374**	4,714
Funds under management	**3,969**	4,833
Other	**6,085**	6,409
Fee income	**37,751**	41,149
Fee expense	**(6,984)**	(6,208)
Net fee income	**30,767**	34,941

Financial Review (continued)

Net Trading Income

Trading income rose by 33.1 per cent to HK$21,363 million. Favourable trading profits benefited from market volatility, redeployment of a growing commercial surplus to support trading activities and lower funding costs against the backdrop of falling interest rates. Increased market volatility led to increased customer volumes and trading opportunities in foreign exchange and interest rate products. Despite favourable underlying performance across Asia, Hong Kong was adversely affected by the impact of a write-down of a single exposure to a monoline insurer and revaluation losses on Guaranteed Provident Fund provisions.

(HK$ millions)	2008	2007
Dealing profits	13,462	12,831
(Loss)/Gain from hedging activities	(73)	63
Net interest income	7,215	2,678
Dividend income from trading securities	759	484
Net trading income	21,363	16,056

Gains Less Losses from Financial Investments

The net loss on financial investments in 2008 included significant write-downs of strategic investments of HK$4,783 million, in accordance with accounting standards, partly offset by gains on sales of shares in MasterCard and Visa. Prior period gains included the disposal of Philippines government securities and equity securities held by Hang Seng Bank.

(HK$ millions)	2008	2007
Gains on disposal of available-for-sale securities	1,807	892
Impairment of available-for-sale equity investments	(4,783)	–
	(2,976)	892

Other Operating Income

'Other' mainly consists of recoveries of IT and other operating costs that were incurred on behalf of fellow HSBC Group companies. In 2008, other income included the recovery gains on loans acquired from The Chinese Bank. A lower surplus arising on property revaluation was driven by write-downs in the second half of 2008 which offset gains made in the first half, reflecting falling property market prices in Hong Kong.

(HK$ millions)	2008	2007
Rental income from investment properties	153	151
Movement in present value of in-force insurance business	823	950
Gains on investment properties	11	564
(Loss)/ profit on disposal of property, plant and equipment, and assets held for sale	(63)	64
(Loss)/ profit on disposal of subsidiaries, associates and business portfolios	(96)	96
Surplus arising on property revaluation	60	122
Other	3,188	2,109
Other operating income	4,076	4,056

Insurance Income

Gains less losses from financial investments in the insurance business includes a significant write-down of a strategic investment in 2008. Changes in the fair value of assets supporting linked insurance contracts are reported in 'Net income from financial instruments designated at fair value' but with offsetting movements in the value of those contracts in 'Net insurance claims incurred and movement in policyholder liabilities'.

(HK$ millions)	2008	2007
Net interest income	**3,369**	2,892
Net fee income	**1,159**	1,738
Net trading income	**(126)**	3
Net (loss)/ income from financial instruments designated at fair value	**(11,471)**	6,894
Gains less losses from financial investments	**(1,468)**	4
Dividend income	**1**	1
Net earned insurance premiums	**26,886**	23,695
Movement in present value of in-force business	**823**	950
Other operating income	**307**	112
	19,480	36,289
Net insurance claims incurred and movement in policyholder liabilities	**(14,767)**	(27,021)
Net operating income	**4,713**	9,268

Loan Impairment Charges and Other Credit Risk Provisions

The net charge for loan impairment and other credit risk provisions was HK$6,195 million higher than the previously low level in 2007.

The increase in individually assessed impairment allowances was largely related to corporate lending, reflecting increasing financial difficulties experienced by companies across the region, notable in Hong Kong, India, Indonesia and Taiwan. This was partly offset by non-recurring charges attributable to the financial trouble of certain customers in Thailand in 2007.

The net charge for collectively assessed impairment allowances increased, primarily as India continued to incur higher credit card delinquencies on the back of increased card spending and a poor economic environment. Hong Kong also reported higher write-downs against personal loans and cards. Meanwhile, higher charges in Australia were consistent with the growth in the card business. In Taiwan, there were lower provisions due to an improvement in asset quality.

In the second half of 2008, the group incurred significant write-downs on exposures against certain financial institutions which are reported as other credit risk provisions.

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

	2008	2007
Hong Kong	**4,210**	1,654
Rest of Asia-Pacific	**5,891**	4,006
Americas/Europe	**(8)**	–
Total	**10,093**	5,660

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

	2008	2007
Net charge for impairment of customer advances		
– Individually assessed impairment allowances:		
New allowances	**4,243**	1,884
Releases	**(523)**	(646)
Recoveries	**(169)**	(197)
	3,551	1,041
– Net charge for collectively assessed impairment allowances	**6,542**	4,619
	10,093	5,660
Net charge for other credit risk provisions	**1,907**	145
Net charge for loan impairment and other credit risk provisions	**12,000**	5,805

Financial Review (continued)

Operating Expenses

Staff costs increased by HK$1,701 million, or 6.4 per cent, compared with 2007. Wages and salaries rose by 20.6 per cent as a result of higher headcounts through acquisitions and organic investment for long-term growth across the region, including the operations of The Chinese Bank in Taiwan and IL&FS Investsmart in India. Headcount increased in mainland China to support new branch openings, in India as a result of expansion of the Commercial Banking business and in Hong Kong to support business expansion generally. However, in recent months, headcount has been reduced as efforts have been made to control costs against the backdrop of a more uncertain outlook for revenues. Wages and salary increases also reflected talent retention in a competitive labour market earlier in the year.

Performance-related pay fell by HK$2,191 million, reflecting the less favourable performance in Hong Kong in 2008, especially when compared to strong 2007 results.

Staff numbers by region*

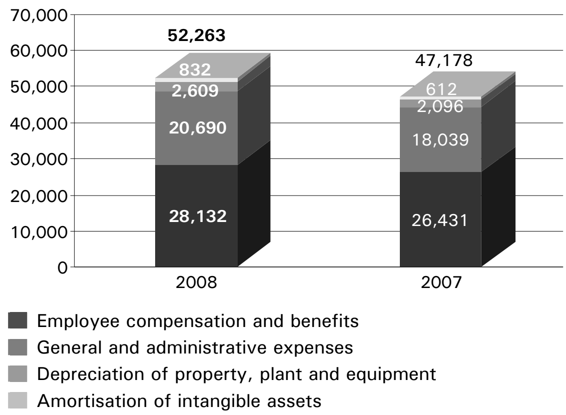
	2008	2007
Hong Kong:		
The bank and wholly owned subsidiaries	**19,499**	18,036
Hang Seng Bank Hong Kong	**8,256**	8,033
Total Hong Kong	**27,755**	26,069
Rest of Asia-Pacific:		
Australia	**1,653**	1,458
Mainland China	**7,300**	6,356
India	**9,292**	7,243
Indonesia	**2,893**	2,590
Singapore	**2,857**	2,473
Taiwan	**3,030**	2,144
Sri Lanka	**1,646**	1,843
Others	**9,128**	9,160
Total rest of Asia-Pacific	**37,799**	33,267
Americas/Europe	**17**	18
Total	**65,571**	59,354

* *Full time equivalent*

General and administrative expenses increased by HK$2,651 million, or 14.7 per cent. Factors contributing to higher expenditures included ongoing business expansion, transaction volumes and higher external supplier costs. Hong Kong, mainland China, India and Taiwan all reported higher expenses in IT, legal and professional fees, consultancy, collection and processing. Premises costs rose as a result of higher rental prices on lease renewal and branch refurbishments, particularly in Hong Kong. Partly offsetting these increases was a fall in marketing expenses as marketing activities were reduced in the second half of the year. However, litigation costs increased significantly due to the combined effect of a non-recurring release in 2007 and new charges in 2008.

	2008	2007
Cost efficiency ratio (%)	**42.1**	37.1

Operating expenses (HK$ millions)



Share of Profit in Associates and Joint Ventures

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

(HK$ millions)	2008	2007
Share of profit in associates and joint ventures	**7,689**	4,735

Tax Expense

The effective rate of tax for 2008 was 18.8 per cent compared with 17.1 per cent in 2007. The increase was mainly attributable to the profit mix with a larger proportion of income being generated in jurisdictions with a higher tax rate.

	2008	2007
Effective rate of tax (%)	**18.8**	17.1

Assets

Total assets increased by HK$308 billion, or 7.8 per cent, since 31 December 2007.

Cash and short-term funds decreased by HK$197 billion, or 24.8 per cent, as a result of a move away from inter-bank lending to Treasury bills and government sponsored corporate securities. However, this was partly offset by increased placements with central banks.

Trading assets rose by HK$133 billion, or 36.9 per cent, primarily as a result of the switch discussed above. The increase in trading assets partly offsets the fall in cash and short-term placements.

Net advances to customers increased by HK$74 billion, or 6.1 per cent, since the end of 2007.

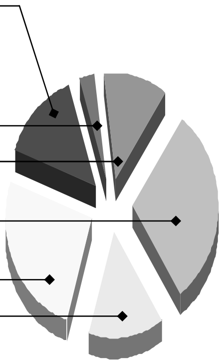
Net advances in Hong Kong rose by HK$82 billion, or 12.4 per cent. Mortgage lending increased by 12.8 per cent due to successful campaigns by the bank in Hong Kong and Hang Seng Bank. This excludes the impact of the fall in lending under the Government Home Ownership Scheme which remained suspended throughout 2008. Corporate and commercial loan balances increased by HK$75 billion, or 22.2 per cent mainly in commercial, industrial and international trade and property lending.

In the rest of Asia-Pacific, net advances decreased by HK$8.4 billion, or 1.5 per cent, since the end of 2007, affected by the depreciation in currencies across the region. On a constant currency basis, net advances increased by HK$40.1 billion, or 8.0 per cent with strong growth in the commercial, industrial and international trade sector, notably in Singapore and Mauritius. However, this increase was partly offset by a fall in lending in mainland China.

Financial investments rose by HK$54 billion, or 10.1 per cent. There was a notable switch during 2008 from equity securities to debt securities as the impact of the fall in the equity markets began to have an impact with debt securities increasing by HK$99 billion and equity securities decreasing by HK$45 billion.

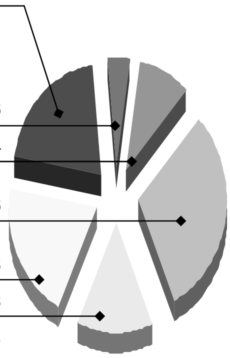
Assets 2008*

	%	*HK$ millions*
Cash and short-term funds	**14.4**	**597,572**
Placings with banks maturing after one month and certificates of deposit	**2.7**	**112,647**
Trading assets	**11.9**	**493,670**
Advances to customers	**31.1**	**1,286,145**
Financial investments	**14.2**	**586,161**
Other	**25.7**	**1,065,137**
Total	**100.0**	**4,141,332**



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



* *Excluding Hong Kong SAR Government certificates of indebtedness*

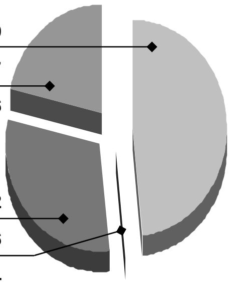
Financial Review (continued)

Customer Accounts

Customer accounts increased by HK$90.0 billion, or 3.6 per cent, compared with the end of 2007.

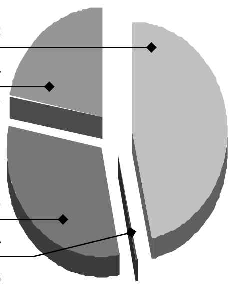
Customer accounts 2008 by region

	%	HK$ millions
Hong Kong excluding Hang Seng Bank	**48.2**	**1,242,079**
Hang Seng Bank	**21.3**	**548,977**
Total Hong Kong	**69.5**	**1,791,056**
Rest of Asia-Pacific	**30.4**	**782,482**
Americas/Europe	**0.1**	**2,546**
Total	**100.0**	**2,576,084**



Customer accounts 2007 by region

	%	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



In Hong Kong, customer accounts rose by HK$84.5 billion, or 5.0 per cent. Despite the low interest rate environment, growth in core deposits was due to customer preference for cash deposits over other investments and capital inflows from mainland China. Deposits from Personal Financial Services and Commercial Banking increased HK$116.6 billion, or 11.6 per cent, and HK$23.1 billion, or 5.8 per cent, respectively. However, customer accounts in Global Banking and Markets fell by HK$52.1 billion or 17.9 per cent.

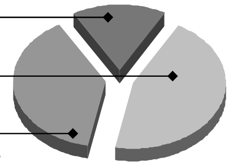
In the Rest of Asia-Pacific, customer accounts increased by HK$5.5 billion, or 0.7 per cent, through growth in both savings and current accounts. Deposits from Personal Financial Services increased by HK$25 billion, or 10 per cent, but this increase was offset by decreases in Global Banking and Markets of HK$21.5 billion, or 6.3 per cent, and in Commercial Banking of HK$4.2 billion, or 2.4 per cent. Mainland China continued to generate strong growth in deposits from all customer groups through ongoing branch network expansion. Another contributing factor was stronger demand for savings products over equity-linked investments as equity market conditions worsened. Japan and Singapore also reported higher customer accounts on the back of business expansion (especially Personal Financial Services) and marketing activities to attract new customers.

The group's advances-to-deposits ratio increased to 49.9 per cent at 31 December 2008, from 48.8 per cent at 31 December 2007.

	2008	2007
Advances: deposits ratio (%)	**49.9**	48.8

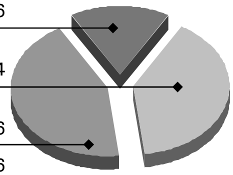
Customer accounts 2008

	%	HK$ millions
Current accounts	**15.9**	**408,891**
Savings accounts	**45.5**	**1,172,406**
Other deposit accounts	**38.6**	**994,787**
Total	**100.0**	**2,576,084**



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



Equity

Equity decreased by HK$29 billion, or 12.0 per cent, to HK$216 billion. The decrease was principally due to the fall in the available-for-sale securities reserve, which largely comprised the decrease in the value of the group's investments in Ping An Insurance and the Bank of Shanghai. This decrease was partly offset by the increase in retained earnings.

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.

From 1 January 2008, The Hongkong and Shanghai Banking Corporation Limited migrates to the foundation internal ratings-based approach and internal ratings-based (securitisation) approach to calculate its credit risk for majority of its non-securitisation exposures and credit risk for securitisation exposures respectively. As a result of the change in basis used to determine credit risk, the numbers for 2007 are not strictly comparable. However, there is not change in the approaches used to calculate operational risk and market risk.

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

Financial Review (continued)

Capital Adequacy *(continued)*

Figures in HK$m	2008	2007
Composition of capital		
Core Capital:		
Paid-up ordinary share capital	**21,040**	21,040
Paid-up irredeemable non-cumulative preference shares	**51,561**	51,882
Published reserves	**84,262**	72,069
Profit and loss account	**19,953**	29,543
Minority interests*	**16,087**	21,318
Less: Deduction from core capital	**(14,457)**	(11,111)
Less: 50% of total amount of deductible items (@50%)**	**(32,212)**	(28,894)
Total core capital	**146,234**	155,847
Supplementary Capital:		
Property revaluation reserves***	**6,655**	5,869
Available-for-sale investments revaluation reserves****	**2,881**	4,434
Unrealised fair value gains from financial instruments designated at fair value through profit or loss	**1**	137
Regulatory reserve*****	**723**	4,148
Collective provisions*****	**908**	5,078
Surplus provisions******	**2,904**	–
Perpetual subordinated debt	**9,410**	9,415
Paid-up irredeemable cumulative preference shares	**16,508**	16,610
Term subordinated debt	**11,786**	11,970
Paid-up term preference shares	**24,800**	21,835
Less: 50% of total amount of deductible items (@ 50%)**	**(32,212)**	(28,894)
Total supplementary capital	**44,364**	50,602
Capital base	**190,598**	206,449
Total deductible items**	**64,424**	57,788

* *After deduction of minority interests.*

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

*** *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.*

***** *Total regulatory reserve and collective provisions are apportioned between the standardised approach and internal ratings-based approach in accordance with guidelines issued by the HKMA. Those apportioned to the standardised approach are included in the supplementary capital. Those apportioned to the standardised approach are included in the supplementary capital. Those apportioned to the internal ratings-based approach are excluded from the supplementary capital.*

****** *Surplus provisions represent the excess of the total eligible provisions over the total expected loss amount. Surplus provisions are applicable to non-securitisation exposures calculated by using internal ratings-based approach.*

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

	2008	2007
Capital adequacy ratio	**13.4%**	11.6%
Core capital ratio	**10.3%**	8.8%

Non-bank Mainland exposures

The analysis of non-bank Mainland exposures is based on the categories of non-bank counterparties and the type of direct exposures defined by the HKMA under the Banking (Disclosure) Rules with reference to the HKMA return for non-bank Mainland exposures, which includes the mainland exposures extended by the Bank and its banking subsidiary in mainland China as at 31 December 2008 and the Bank as at 31 December 2007.

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 2008.

At 31 December 2008

	On-balance sheet exposure	**Off-balance sheet exposure**	**Total exposures**	**Specific provisions**
	HK$m	**HK$m**	**HK$m**	**HK$m**
Mainland entities	**18,541**	**14,842**	**33,383**	**–**
Companies and individuals outside the Mainland where the credit is granted for use in Mainland	**42,692**	**40,044**	**82,736**	**685**
Other counterparties the exposures to whom are considered by the bank to be non-bank Mainland exposures	**509**	**3,086**	**3,595**	**–**
	61,742	**57,972**	**119,714**	**685**
Mainland exposures of HBCN	**60,709**	**13,508**	**74,217**	**60**
	122,451	**71,480**	**193,931**	**745**

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

Financial Review (continued)

Overdue and rescheduled advances

Over due and rescheduled advances are shown in Notes 18d and 18e on the Accounts respectively on pages 83 to 87.

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

HK$ millions	Hong Kong	Rest of Asia-Pacific	Americas/ Europe/ Others	Total
At 31 December 2008				
Gross advances to customers	**681,961**	**523,186**	**91,956**	**1,297,103**
At 31 December 2007				
Gross advances to customers	627,942	497,888	93,516	1,219,346

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 2008

(HK$ millions)	Banks and Other Financial Institutions	Public Sector Entities	Other	Total
Americas				
United States	**96,870**	**122,594**	**48,225**	**267,689**
Other	**24,459**	**4,171**	**82,817**	**111,447**
	121,329	**126,765**	**131,042**	**379,136**
Europe				
United Kingdom	**349,284**	**575**	**28,651**	**378,510**
Other	**221,598**	**8,571**	**62,754**	**292,923**
	570,882	**9,146**	**91,405**	**671,433**
Asia-Pacific excluding Hong Kong	**158,481**	**168,458**	**167,597**	**494,536**

As at 31 December 2007

(HK$ millions)	Banks and Other Financial Institutions	Public Sector Entities	Other	Total
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

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

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

Credit risk, liquidity risk, market risk, operational risk, insurance risk and capital management are discussed in detail in note 52 to the Financial Statements on pages 162 to 194.

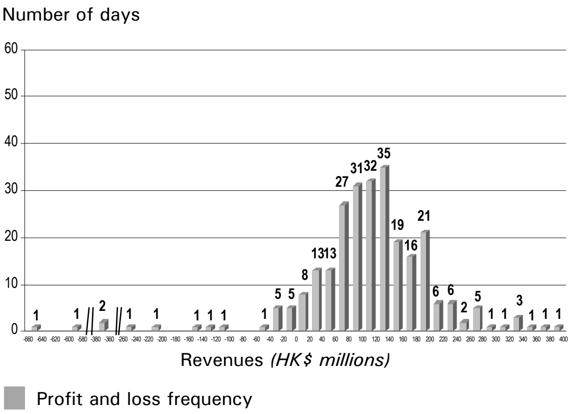
Market Risk Management

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 176 to 180.

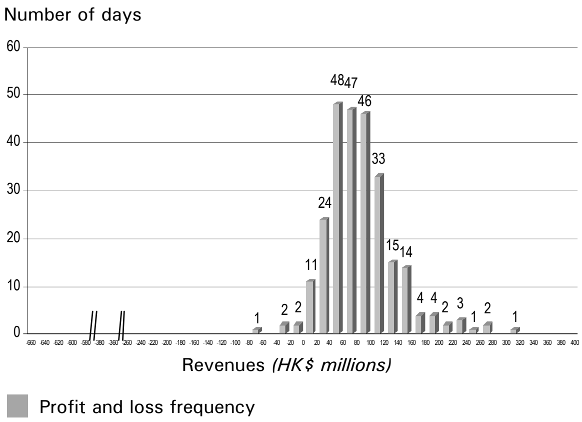
The average daily revenue earned from market risk-related treasury activities in 2008, including accrual book net interest income and funding related to dealing positions, was HK$105 million compared with HK$84 million in 2007. The standard deviation of these daily revenues was HK$113 million (HK$52 million for 2007).

An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on 20 days in 2008. The most frequent result was a daily revenue of between HK$120 million and HK$140 million with 35 occurrences. The highest daily revenue was HK$390 million. The most frequent result in 2007 was a daily revenue of between HK$40 million and HK$60 million with 48 occurrences. The highest daily revenue in 2007 was HK$305 million.

Daily distribution of market risk revenues 2008



Daily distribution of market risk revenues 2007



Financial Review (continued)

Operational Risk Management

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

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

The HSBC Group has codified its operational risk management process by issuing a high level standard, supplemented by more detailed formal guidance. This explains how the group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The standard covers the following:

- operational risk management responsibility is assigned to senior management within the business operation;
- information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting;
- assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;
- operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the 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 2008

	Note	**2008 HK$m**	2007 HK$m
Interest income	*5a*	**125,864**	144,153
Interest expense	*5b*	**(56,819)**	(81,392)
Net interest income		**69,045**	62,761
Fee income		**37,751**	41,149
Fee expense		**(6,984)**	(6,208)
Net fee income	*5c*	**30,767**	34,941
Net trading income	*5d*	**21,363**	16,056
Net (loss)/ income from financial instruments designated at fair value	*5e*	**(10,982)**	6,201
Gains less losses from financial investments	*5f*	**(2,976)**	892
Gains from dilution of investments in associates	*5g*	**–**	4,735
Dividend income	*5h*	**852**	693
Net earned insurance premiums	*5i*	**26,886**	23,695
Other operating income	*5j*	**4,076**	4,056
Total operating income		**139,031**	154,030
Net insurance claims incurred and movement in policyholders' liabilities	*5k*	**(14,767)**	(27,021)
Net operating income before loan impairment charges and other credit risk provisions		**124,264**	127,009
Loan impairment charges and other credit risk provisions	*5l*	**(12,000)**	(5,805)
Net operating income		**112,264**	121,204
Employee compensation and benefits	*5m*	**(28,132)**	(26,431)
General and administrative expenses	*5n*	**(20,690)**	(18,039)
Depreciation of property, plant and equipment	*25*	**(2,609)**	(2,096)
Amortisation of intangible assets	*24c*	**(832)**	(612)
Total operating expenses		**(52,263)**	(47,178)
Operating profit		**60,001**	74,026
Share of profit in associates and joint ventures		**7,689**	4,735
Profit before tax		**67,690**	78,761
Tax expense	*6*	**(12,710)**	(13,456)
Profit for the year		**54,980**	65,305
Profit attributable to shareholders		**50,306**	58,028
Profit attributable to minority interests		**4,674**	7,277

Consolidated Balance Sheet at 31 December 2008

	Note	2008 HK$m	2007 HK$m
ASSETS			
Cash and short-term funds	*10*	**597,572**	794,923
Items in the course of collection from other banks		**13,949**	20,357
Placings with banks maturing after one month	*11*	**55,569**	60,328
Certificates of deposit	*12*	**57,078**	97,358
Hong Kong SAR Government certificates of indebtedness	*13*	**119,024**	108,344
Trading assets	*14*	**493,670**	360,704
Financial assets designated at fair value	*15*	**40,553**	63,152
Derivatives	*16*	**453,923**	180,440
Advances to customers	*17*	**1,286,145**	1,212,086
Financial investments	*20*	**586,161**	532,243
Amounts due from Group companies		**378,662**	364,724
Investments in associates and joint ventures	*23*	**48,270**	39,832
Goodwill and intangible assets	*24*	**16,181**	12,309
Property, plant and equipment	*25*	**35,885**	33,356
Deferred tax assets	*34*	**1,699**	1,566
Retirement benefit assets	*5m*	**84**	123
Other assets	*27*	**75,931**	70,094
Total assets		**4,260,356**	3,951,939
LIABILITIES			
Hong Kong SAR currency notes in circulation	*13*	**119,024**	108,344
Items in the course of transmission to other banks		**31,334**	31,586
Deposits by banks		**196,674**	169,177
Customer accounts	*28*	**2,576,084**	2,486,106
Trading liabilities	*29*	**210,587**	265,675
Financial liabilities designated at fair value	*30*	**39,926**	38,147
Derivatives	*16*	**466,204**	173,322
Debt securities in issue	*31*	**48,800**	84,523
Retirement benefit liabilities	*5m*	**7,486**	1,537
Amounts due to Group companies		**51,244**	65,846
Other liabilities and provisions	*32*	**63,319**	70,203
Liabilities under insurance contracts issued	*33*	**113,431**	91,730
Current tax liabilities	*6*	**3,270**	5,833
Deferred tax liabilities	*34*	**4,433**	5,148
Subordinated liabilities	*36*	**19,184**	18,500
Preference shares	*38*	**92,870**	90,328
Total liabilities		**4,043,870**	3,706,005
EQUITY			
Share capital	*39*	**22,494**	22,494
Other reserves	*40*	**36,863**	83,952
Retained profits	*40*	**123,085**	107,908
Proposed fourth interim dividend	*8*	**11,170**	6,500
Total shareholders' equity		**193,612**	220,854
Minority interests	*40*	**22,874**	25,080
Total equity		**216,486**	245,934
Total equity and liabilities		**4,260,356**	3,951,939

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

Secretary
M W Scales

Balance Sheet at 31 December 2008

	Note	2008 HK$m	2007 HK$m
ASSETS			
Cash and short-term funds	*10*	**481,702**	637,771
Items in the course of collection from other banks		**9,908**	13,946
Placings with banks maturing after one month	*11*	**33,754**	39,842
Certificates of deposit	*12*	**36,980**	48,788
Hong Kong SAR Government certificates of indebtedness	*13*	**119,024**	108,344
Trading assets	*14*	**329,123**	260,107
Financial assets designated at fair value	*15*	**1,728**	2,861
Derivatives	*16*	**452,209**	178,184
Advances to customers	*17*	**817,996**	743,530
Financial investments	*20*	**340,800**	254,225
Amounts due from group companies		**397,961**	381,236
Investments in subsidiary companies	*22*	**16,956**	16,374
Investments in associates and joint ventures	*23*	**21,132**	20,461
Goodwill and intangible assets	*24*	**6,368**	4,027
Property, plant and equipment	*25*	**21,384**	19,295
Deferred tax assets	*34*	**819**	977
Retirement benefit assets	*5m*	**52**	51
Other assets	*27*	**50,012**	49,617
Total assets		**3,137,908**	2,779,636
LIABILITIES			
Hong Kong SAR currency notes in circulation	*13*	**119,024**	108,344
Items in the course of transmission to other banks		**26,581**	22,837
Deposits by banks		**174,532**	126,604
Customer accounts	*28*	**1,767,001**	1,722,000
Trading liabilities	*29*	**151,089**	168,299
Financial liabilities designated at fair value	*30*	**7,086**	3,366
Derivatives	*16*	**457,732**	170,993
Debt securities in issue	*31*	**34,855**	48,183
Retirement benefit liabilities	*5m*	**3,550**	875
Amounts due to group companies		**117,681**	100,966
Other liabilities and provisions	*32*	**47,897**	52,848
Current tax liabilities	*6*	**2,580**	3,430
Deferred tax liabilities	*34*	**2,107**	2,402
Subordinated liabilities	*36*	**10,602**	9,811
Preference shares	*38*	**92,870**	90,328
Total liabilities		**3,015,187**	2,631,286
EQUITY			
Share capital	*39*	**22,494**	22,494
Other reserves	*40*	**19,633**	61,260
Retained profits	*40*	**69,424**	58,096
Proposed fourth interim dividend	*8*	**11,170**	6,500
Total equity		**122,721**	148,350
Total equity and liabilities		**3,137,908**	2,779,636

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 2008

	2008 **HK$m**	2007 HK$m
Available-for-sale investments:		
– fair value changes taken to equity	**(46,506)**	35,801
– fair value changes transferred to the income statement on disposal	**(1,709)**	(959)
– fair value changes transferred to the income statement on impairment	**2,682**	–
– fair value changes transferred to the income statement on hedged items due to hedged risk	**(1,973)**	(594)
Cash flow hedges:		
– fair value changes taken to equity	**4,182**	555
– fair value changes transferred to the income statement	**(2,652)**	632
Property revaluation:		
– fair value changes taken to equity	**1,946**	3,291
Share of changes in equity of associates and joint ventures	**97**	14
Exchange differences	**(6,996)**	6,292
Actuarial losses on post-employment benefits	**(6,194)**	(3,568)
	(57,123)	41,464
Net deferred tax on items taken directly to equity	**1,116**	45
Total income and expense taken to equity during the year	**(56,007)**	41,509
Profit for the year	**54,980**	65,305
Total recognised income and expense for the year	**(1,027)**	106,814
Total recognised income and expense for the year attributable to:		
– shareholders	**(1,968)**	98,085
– minority interests	**941**	8,729
	(1,027)	106,814

Consolidated Cash Flow Statement for the Year Ended 31 December 2008

	Note	2008 HK$m	2007 HK$m
Operating activities			
Cash (used in)/ generated from operations	*43*	**(75,489)**	292,331
Interest received on financial investments		**17,548**	21,393
Dividends received on financial investments		**697**	585
Dividends received from associates		**3,005**	1,208
Taxation paid		**(14,586)**	(11,942)
Net cash (outflow) / inflow from operating activities		**(68,825)**	303,575
Investing activities			
Purchase of financial investments		**(632,954)**	(436,191)
Proceeds from sale or redemption of financial investments		**570,372**	443,128
Purchase of property, plant and equipment		**(3,269)**	(3,197)
Proceeds from sale of property, plant and equipment and assets held for sale		**218**	1,214
Purchase of other intangible assets		**(1,757)**	(1,271)
Net cash outflow in respect of the acquisition of and increased shareholding in subsidiary companies	*44c*	**(1,240)**	(134)
Net cash inflow in respect of the sale of subsidiary companies	*44d*	**–**	111
Net cash inflow in respect of the purchase of interests in business portfolios	*44f*	**13,992**	1,999
Net cash outflow in respect of the purchase of interests in associates and joint ventures		**(2,643)**	(3,628)
Net cash (outflow)/ inflow from the sale of interests in business portfolios	*44e*	**(33)**	1,948
Proceeds from the sale of interests in associates		**–**	238
Net cash (outflow) / inflow from investing activities		**(57,314)**	4,217
Net cash (outflow) / inflow before financing		**(126,139)**	307,792
Financing			
Issue of preference share capital		**3,113**	13,587
Change in minority interests		**1,893**	688
Repayment of subordinated liabilities		**–**	(463)
Issue of subordinated liabilities		**296**	2,345
Ordinary dividends paid		**(26,500)**	(23,000)
Dividends paid to minority interests		**(4,664)**	(5,153)
Interest paid on preference shares		**(5,752)**	(5,144)
Interest paid on subordinated liabilities		**(1,039)**	(1,166)
Net cash outflow from financing		**(32,653)**	(18,306)
(Decrease) / increase in cash and cash equivalents	*44a*	**(158,792)**	289,486

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') as of 31 December 2008.

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 ventures based on accounts made up to dates not earlier than three months prior to 31 December 2008.

c During the year the group adopted the following interpretations and one amendment under HKFRS:

Hong Kong (IFRIC) Interpretation 11 'Group and Treasury Share Transactions' (HK(IFRIC)-Int 11). On application of this interpretation, the group recognises all share-based payment transactions as equity-settled, whereby the fair value of the awards at grant date is recognised in equity. Previously, certain share-based payment transactions involving principally achievement and restricted share awards were recognised as cash-settled transactions and a liability was recognised in respect of the fair value of such awards at each reporting date. The effect of the adoption of HK(IFRIC)-Int 11 was not considered to be material for the group and therefore, the prior year figures have not been restated;

Hong Kong (IFRIC) Interpretation 12 'Service Concession Arrangements', which has no significant effect on the consolidated financial statements of the group;

Hong Kong (IFRIC) Interpretation 14 'HKAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction', which had no effect on the consolidated financial statements of the group; and

Amendment to HKAS 39 'Financial Instruments: Recognition and Measurement' and HKFRS 7 'Financial Instruments: Disclosures' on reclassification of financial assets and its related amendment on effective date and transition requirements, which had no effect on the consolidated financial statements of the group.

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.

Disclosures under HKFRS4 and HKFRS7 relating to the nature and extent of risks have been included in note 52 'Risk management'.

Disclosures relating to 'Impact of market turmoil' are included in note 53.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is included in note 4h and is discussed further within note 16 'Derivatives' and note 37 'Fair value of financial instruments'.

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

- The likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgment may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt;

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

- An appropriate discount rate for the instrument. Management determines this rate based on its assessment of the appropriate spread of the rate for the instrument over the risk-free rate; and
- Judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative models

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

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

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

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

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.

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).

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

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 52.

Income taxes

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

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

Held-to-maturity securities

As indicated in note 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 2008 are disclosed in note 37.

3 Comparative figures

Certain comparative figures have been restated to reflect changes in presentation in the current year disclosure.

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).

(ii) Dividend income

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

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

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

(iv) Net trading income

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

c *Advances to customers and placings with banks*

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

4 Principal accounting policies *(continued)*

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).

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.

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

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

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

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and capability to trade successfully out of financial difficulties and generate sufficient cash flow to service their debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, 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.

4 Principal accounting policies *(continued)*

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

(ii) Collectively assessed loans

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

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

Incurred but not yet identified impairment

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

The collective impairment loss is determined after taking into account:

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

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

Homogeneous groups of loans

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

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

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

(iii) Loan write-offs

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

4 Principal accounting policies *(continued)*

(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.

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'.

4 Principal accounting policies *(continued)*

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

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

g *Financial investments*

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

Available-for-sale

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

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

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

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

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

4 Principal accounting policies *(continued)*

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

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

Held-to-maturity investments

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

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h *Determination of fair value*

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

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets 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.

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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 4e. 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 rate method is used is amortised to the income statement over the residual period to maturity in 'Net interest income'. Where the adjustment relates to the carrying amount of a hedged available-for-sale equity security, this remains in equity until the disposal of the equity security.

Cash flow hedge

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

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

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

Net investment hedge

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

Hedge effectiveness testing

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

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

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 ventures in the consolidated balance sheet are stated at the group's attributable share of the net assets of the associates and joint ventures 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.

n *Goodwill and intangible assets*

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

4 Principal accounting policies *(continued)*

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

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

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

(ii) Intangible assets include the present value of in-force long-term assurance business, operating rights, 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 professional qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value. Surpluses arising on revaluation are credited firstly to the income statement to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same premises, and are thereafter taken to the 'Property revaluation reserve'. Deficits arising on revaluation are first set off against any previous revaluation surpluses included in the 'Property revaluation reserve' in respect of the same 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 professional 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 period 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.

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.

s *Share-based payments*

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

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

4 Principal accounting policies *(continued)*

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

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

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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.

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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.

Notes on the Financial Statements (continued)

4 Principal accounting policies *(continued)*

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.

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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.

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x *Dividends*

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

4 Principal accounting policies *(continued)*

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*

	2008 **HK$m**	2007 HK$m
Interest income on listed securities	**8,374**	6,456
Interest income on unlisted securities	**23,993**	28,771
Other interest income	**106,771**	121,569
	139,138	156,796
Less: interest income classified as 'Net trading income' (note 5d)	**(13,168)**	(12,041)
Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 5e)	**(106)**	(602)
	125,864	144,153

Included in the above is interest income accrued on impaired financial assets of HK$341 million (*2007:HK$400 million*), including unwinding of discounts on loan impairment losses of HK$280 million *(2007:HK$308 million).*

b *Interest expense*

	2008 **HK$m**	2007 HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**1,375**	2,111
Interest expense on preference shares	**4,946**	5,346
Other interest expense	**56,493**	83,430
	62,814	90,887
Less: interest expense classified as 'Net trading income' (note 5d)	**(5,953)**	(9,363)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 5e)	**(42)**	(132)
	56,819	81,392

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

c *Net fee income*

	2008	2007
	HK$m	HK$m
Net fee income includes the following:		
Net fee income, other than amounts included in determining the effective interest rate, arising from financial assets or financial liabilities that are not held for trading or designated at fair value		
– fee income	**11,196**	9,404
– fee expense	**(1,115)**	(877)
	10,081	8,527
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**7,294**	9,078
– fee expense	**(819)**	(863)
	6,475	8,215

d *Net trading income*

	2008	2007
	HK$m	HK$m
Dealing profits		
– Foreign exchange	**12,696**	8,650
– Interest rate derivatives	**2,999**	1,677
– Debt securities	**673**	(48)
– Equities and other trading	**(2,906)**	2,552
	13,462	12,831
Gain/ (loss) from hedging activities		
Fair value hedges		
– Net gain on hedged items attributable to the hedged risk	**2,000**	563
– Net loss on hedging instruments	**(2,023)**	(498)
Cash flow hedges		
– Net hedging loss	**(50)**	(2)
	(73)	63
Interest on trading assets and liabilities		
– Interest income (note 5a)	**13,168**	12,041
– Interest expense (note 5b)	**(5,953)**	(9,363)
	7,215	2,678
Dividend income from trading securities		
– Listed investments	**759**	484
	21,363	16,056

5 Operating profit *(continued)*

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

	2008	2007
	HK$m	HK$m
(Expense)/ income on assets designated at fair value which back insurance and investment contracts	**(15,714)**	8,405
Change in fair value of investment contracts relating to insurance entities	**3,596**	(2,740)
	(12,118)	5,665
Net change in fair value of other financial assets/liabilities designated at fair value[1]	**1,072**	66
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 5a)	**106**	602
– Interest expense (note 5b)	**(42)**	(132)
	64	470
	(10,982)	6,201

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 2008 the group recognised a HK$66 million gain on changes in the fair value of these instruments arising from changes in own credit risk (2007:HK$12 million).*

f *Gains less losses from financial investments*

	2008	2007
	HK$m	HK$m
Gains on disposal of available-for-sale securities	**1,807**	892
Impairment of available-for-sale equity investments	**(4,783)**	–
	(2,976)	892

g *Gains arising from dilution of investments in associates*

During 2007, 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 to the new share issue. This increase in the group's share of net assets was regarded as a gain arising from deemed disposals of part of its interests in the associates and it has been separately 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.

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

h *Dividend income*

	2008 **HK$m**	2007 HK$m
Listed investments	**694**	463
Unlisted investments	**158**	230
	852	693

i *Net earned insurance premiums*

2008	*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	**2,581**	**23,736**	**5,570**	**24**	**31,911**
Movement in unearned premiums	**(139)**	**–**	**–**	**–**	**(139)**
Gross earned premiums	**2,442**	**23,736**	**5,570**	**24**	**31,772**
Gross written premiums ceded to reinsurers	**(351)**	**(182)**	**(4,357)**	**–**	**(4,890)**
Reinsurers' share of movement in unearned premiums	**4**	**–**	**–**	**–**	**4**
Reinsurers' share of gross earned premiums	**(347)**	**(182)**	**(4,357)**	**–**	**(4,886)**
Net earned premiums	**2,095**	**23,554**	**1,213**	**24**	**26,886**

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

5 Operating profit *(continued)*

j *Other operating income*

	2008	2007
	HK$m	HK$m
Rental income from investment properties	**153**	151
Movement in present value of in-force insurance business	**823**	950
Gains on investment properties	**11**	564
(Loss)/ profit on disposal of property, plant and equipment, and assets held for sale	**(63)**	64
(Loss)/ profit on disposal of subsidiaries, associates and business portfolios	**(96)**	96
Surplus arising on property revaluation	**60**	122
Other	**3,188**	2,109
	4,076	4,056

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

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

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

	Non-life insurance	*Life insurance (non-linked)*	*Life insurance (linked)*	*Investment contracts with discretionary participation features*	*Total*
2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Claims, benefits and surrenders paid	**1,184**	**2,644**	**1,796**	**3**	**5,627**
Movement in provision	**(82)**	**19,954**	**884**	**(12)**	**20,744**
Gross claims incurred and movement in policyholders' liabilities	**1,102**	**22,598**	**2,680**	**(9)**	**26,371**
Reinsurers' share of claims, benefits and surrenders paid	**(121)**	**(58)**	**(234)**	**–**	**(413)**
Reinsurers' share of movement in provision	**75**	**(75)**	**(11,191)**	**–**	**(11,191)**
Reinsurers' share of claims incurred and movement in policyholders' liabilities	**(46)**	**(133)**	**(11,425)**	**–**	**(11,604)**
Net insurance claims incurred and movement in policyholders' liabilities	**1,056**	**22,465**	**(8,745)**	**(9)**	**14,767**

	Non-life insurance	*Life Insurance (non-linked)*	*Life insurance (linked)*	*Investment contracts with discretionary participation features*	*Total*
2007	HK$m	HK$m	HK$m	HK$m	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

5 Operating profit *(continued)*

l *Loan impairment charges and other credit risk provisions*

Net charge for impairment of customer advances	**2008 HK$m**	2007 HK$m
– Individually assessed impairment allowances:		
New allowances	**4,243**	1,884
Releases	**(523)**	(646)
Recoveries	**(169)**	(197)
	3,551	1,041
– Net charge for collectively assessed impairment allowances	**6,542**	4,619
Net charge for other credit risk provisions	**1,907**	145
Net charge for loan impairment and other credit risk provisions	**12,000**	5,805

Included in the net charge for other credit risk provisions is an impairment charge of HK$2,006 million against available-for-sale debt securities (*2007: HK$5 million*). There are no impairment losses or provisions relating to held-to-maturity investments.

m *Employee compensation and benefits*

	2008 HK$m	2007 HK$m
Wages, salaries and other costs	**20,117**	16,687
Performance-related pay	**6,126**	8,317
Social security costs	**549**	327
Retirement benefit costs		
– Defined contribution plans	**779**	628
– Defined benefit plans	**561**	472
	28,132	26,431

Retirement benefit pension plans

The group operates 69 *(2007: 66)* retirement benefit plans, with a total cost of HK$1,340 million *(2007: HK$1,100 million)*, of which HK$539 million *(2007: HK$494 million)* relates to overseas plans and HK$66 million *(2007:HK$72 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 43 per cent *(2007: 45 per cent)* 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$537 million *(2007: HK$442 million)* which was assessed in accordance with the advice of qualified actuaries; the plans are reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the projected benefit obligations of the group's retirement benefits plans vary according to the economic conditions of the countries in which they are situated.

Notes on the Financial Statements (continued)

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:

	2008	2007
	% p.a.	% p.a.
Discount rate	**1.19**	3.45
Expected rate of return on plan assets		
– equities	**8.3**	8.3
– bonds	**4.2**	4.5
– other	**2.1**	6.1
Rate of pay increase		
– long term	**5.0**	5.0
Mortality table	HKLT2001*	HKLT2001*

* *HKLT2001 – Hong Kong Life Tables 2001*

The overall expected long-term rate of return on assets as at 31 December 2008 is 6.7 per cent (2007: 7.2 per cent). 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 Limited and certain other employees of the HSBC Group. The latest actuarial valuation of the defined benefit plan was made at 31 December 2007. At the valuation date, the market value of the defined benefit scheme's assets was HK$9,168 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$1,488 million. On a wind-up basis, the scheme's assets represented 125 per cent of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK$1,837 million. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 6 per cent per annum and long-term salary increases of 5 per cent per annum.

5 Operating profit *(continued)*

(ii) Value recognised in the balance sheet

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Equities	**1,990**	6,954	**926**	4,568
Bonds	**9,090**	7,310	**6,630**	4,579
Other	**2,508**	2,308	**1,823**	1,359
Fair value of plan assets	**13,588**	16,572	**9,379**	10,506
Present value of funded obligations	**20,824**	17,830	**12,719**	11,184
Present value of unfunded obligations	**130**	136	**122**	126
Defined benefit obligations	**20,954**	17,966	**12,841**	11,310
Effect of limit on plan surpluses	**36**	20	**36**	20
Net defined benefit liability	**(7,402)**	(1,414)	**(3,498)**	(824)
Reported as ‘Assets’	**84**	123	**52**	51
Reported as ‘Liabilities’	**(7,486)**	(1,537)	**(3,550)**	(875)
Net defined benefit liability	**(7,402)**	(1,414)	**(3,498)**	(824)

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

	Group		*Bank*	
	2008	2007	**2007**	2006
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**17,966**	13,134	**11,310**	8,674
Current service cost	**1,069**	859	**706**	614
Interest cost	**639**	512	**413**	348
Contributions by employees	**2**	2	**–**	–
Actuarial losses	**2,583**	4,496	**1,430**	2,374
Benefits paid	**(1,152)**	(1,101)	**(847)**	(769)
Past service cost – vested immediately	**3**	–	**3**	–
Gains on curtailments	**–**	(18)	**–**	(17)
Exchange and other movements	**(156)**	82	**(174)**	86
At 31 December	**20,954**	17,966	**12,841**	11,310

(iv) Changes in the fair value of plan assets

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**16,572**	14,860	**10,506**	9,500
Expected return	**1,150**	881	**716**	497
Contributions by the group	**687**	851	**505**	660
Contributions by employees	**2**	2	**–**	–
Actuarial (losses)/ gains	**(3,591)**	948	**(1,400)**	487
Benefits paid	**(1,114)**	(1,050)	**(816)**	(729)
Exchange and other movements	**(118)**	80	**(132)**	91
At 31 December	**13,588**	16,572	**9,379**	10,506

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

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

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Equities	**357**	583	**312**	516
Others	**93**	8	**42**	4
	450	591	**354**	520

The group's actual loss on plan assets for the year ended 31 December 2008 was HK$2,441 million *(2007: HK$1,829 million gain)*. The Bank's actual loss on plan assets for the year ended 31 December 2008 was HK$684 million *(2007: HK$984 million gain)*.

The group expects to make HK$989 million of contributions to defined benefit pension plans during the following year *(2007: HK$748 million)*. Contributions to be made by the Bank are expected to be HK$546 million *(2007: HK$561 million)*.

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

	Group	
	2008	2007
	HK$m	HK$m
Current service cost	**1,069**	859
Interest cost	**639**	512
Expected return on plan assets	**(1,150)**	(881)
Past service costs	**3**	–
Gains on curtailments	**–**	(18)
Total net expense	**561**	472

Total net actuarial losses recognised in the group's total equity during 2008 in respect of defined benefit pension plans was HK$6,194 million *(2007: HK$3,568 million)*. After deduction of minority interests, a loss of HK$5,051 million *(2007: HK$2,998 million)* was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date was HK$9,578 million *(2007: HK$3,384 million)*. After deduction of minority interests, the total net actuarial losses recognised in total shareholders' equity to date was HK$8,000 million *(2007: HK$2,949 million)*.

Total net actuarial losses recognised in the Bank's retained profits during 2008 in respect of defined benefit pension plans were HK$2,850 million *(2007: HK$1,906 million)*. Total net actuarial losses recognised outside of the income statement to date were HK$4,952 million *(2007: HK$2,102 million)*.

The total effect of the limit on plan surpluses recognised within actuarial losses in equity for both the group and the Bank during 2008 was HK$20 million excluding exchange differences of HK$4 million *(2007: HK$20 million excluding exchange difference of HK$1 million)*.

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.

5 Operating profit *(continued)*

The scheme is denominated in Sterling with the following details:

Assumptions as at 31 December	**2008**	2007
	% p.a.	% p.a.
Inflation	**2.90**	3.30
Salary increases	**4.65**	5.05
Pension increases	**2.90**	3.30
Discount rate	**6.50**	5.80
Expected return on assets	**4.12**	5.77
Mortality table	**PNA00YOB***	PA92YOB**

* *The table "PNA00 Year of Birth" was based on the 2000 series of tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries. The factors in this table have been scaled by 90%. An allowance for future improvements in mortality after 2000 has been made in line with those underlying the medium cohort improvements applicable to the series, subject to a minimum improvement of 1% per annum.*

** *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 International Staff Scheme

Funded status at 31 December	**2008**	2007
	£m	£m
Plan assets	**545**	525
Defined benefit obligations	**(523)**	(619)
Net defined benefit surplus/(liabilities)	**22**	(94)

Categories of assets at 31 December	**2008**	2007
	£m	£m
Bonds	**345**	376
Property	**35**	48
Other	**165**	101
Fair value of plan assets	**545**	525

Reconciliation of defined benefit obligations at 31 December	**2008**	2007
	£m	£m
At 1 January	**619**	601
Current service cost	**15**	15
Interest cost	**35**	30
Contributions by employees	**1**	1
Actuarial (gains)/losses	**(114)**	13
Benefits paid	**(33)**	(41)
At 31 December	**523**	619

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

Reconciliation of the fair value of plan assets at 31 December	**2008**	2007
	£m	£m
At 1 January	**525**	504
Expected return	**34**	29
Actuarial gains	**5**	19
Contributions by the group	**13**	13
Contributions by employees	**1**	1
Benefits paid	**(33)**	(41)
At 31 December	**545**	525

Estimated contributions in the following year	**2008**	2007
	£m	£m
Estimated company contributions in the financial year	**14**	14
Estimated employee contributions in the financial year	**1**	1
Estimated total contributions in the financial year	**15**	15

(vi) Amounts for the current and previous years

	Group					*Bank*				
	2008	2007	2006	2005	2004	**2008**	2007	2006	2005	2004
	HK$m	HK$m	HK$m	HK$m	HK$m	**HK$m**	HK$m	HK$m	HK$m	HK$m
Defined benefit obligations	**20,954**	17,966	13,134	11,950	11,626	**12,841**	11,310	8,674	7,726	7,389
Plan assets	**13,588**	16,572	14,860	13,344	12,606	**9,379**	10,506	9,500	8,599	8,095
Net (deficit)/surplus	**(7,366)**	(1,394)	1,726	1,394	980	**(3,462)**	(804)	826	873	706
Experience losses/(gains) on plan liabilities	**132**	790	420	84	(28)	**363**	585	384	71	(76)
Experience (losses)/gains on plan assets	**(3,591)**	948	953	67	99	**(1,400)**	487	499	(5)	9

n *General and administrative expenses*

	2008	2007
	HK$m	HK$m
Premises and equipment		
– Rental expenses	**2,432**	1,957
– Amortisation of prepaid operating lease payments	**59**	59
– Other premises and equipment	**3,068**	2,750
	5,559	4,766
Marketing and advertising expenses	**3,579**	4,170
Other administrative expenses	**11,128**	9,537
Litigation and other provisions	**424**	(434)
	20,690	18,039

Included in operating expenses are direct operating expenses of HK$18 million *(2007: HK$21 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 *(2007: HK$1 million)*.

Included in operating expenses are minimum lease payments under operating leases of HK$2,443 million *(2007: HK$1,918 million)*.

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

o *Auditors' remuneration*

Auditors' remuneration amounted to HK$68 million *(2007: HK$62 million)*, of which HK$30 million *(2007: HK$27 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$107 million *(2007: HK$125 million)*. This comprises fees of HK$6 million *(2007: HK$6 million)* and other emoluments of HK$101 million *(2007: HK$119 million)* which includes pension benefits of HK$5 million *(2007: HK$5 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 16.5% *(2007: 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 2008. 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:

	2008	2007
	HK$m	HK$m
Current income tax		
– Hong Kong profits tax – on current year profit	**6,592**	8,723
– Hong Kong profits tax – adjustments in respect of prior years	**(348)**	(444)
– Overseas taxation – on current year profit	**6,601**	4,835
– Overseas taxation – adjustments in respect of prior years	**(407)**	(184)
	12,438	12,930
Deferred tax (note 34)		
– Origination and reversal of temporary differences	**182**	224
– Adjustments in respect of prior years	**90**	302
	272	526
	12,710	13,456

b *Provisions for taxation*

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong profits tax	**475**	3,322	**319**	1,409
Overseas taxation	**2,795**	2,511	**2,261**	2,021
Current tax liabilities	**3,270**	5,833	**2,580**	3,430
Deferred tax liabilities (note 34)	**4,433**	5,148	**2,107**	2,402
	7,703	10,981	**4,687**	5,832

Notes on the Financial Statements (continued)

6 Tax expense *(continued)*

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

	2008	2007
	HK$m	HK$m
Profit before tax	**67,690**	78,761
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**12,930**	14,699
Tax effect of non-taxable revenue (net of non-deductible expenses)	**(330)**	(789)
Tax effect of prior year's tax losses utilised this year (net of unused tax losses not recognised)	**(3)**	(127)
Over provision in prior years	**(665)**	(326)
Others	**778**	(1)
	12,710	13,456

7 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$44,734 million *(2007: HK$40,601 million)* which has been dealt with in the accounts of the Bank.

8 Dividends

	2008		2007	
	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**	0.72	6,500
– first interim dividend paid	**0.67**	**6,000**	0.56	5,000
– second interim dividend paid	**0.72**	**6,500**	0.61	5,500
– third interim dividend paid	**0.83**	**7,500**	0.67	6,000
	2.94	**26,500**	2.56	23,000

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2008 of HK$11,170 million (HK$1.24 per ordinary share).

9 Financial Assets and Liabilities

Group

	At 31 December 2008								
	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	–	–	–	**336,731**	**131,651**	**129,190**	–	–	**597,572**
Items in the course of collection from other banks	–	–	–	–	–	**13,949**	–	–	**13,949**
Placings with banks maturing after one month	–	–	–	**55,569**	–	–	–	–	**55,569**
Certificates of deposit	–	–	**4,472**	–	**52,606**	–	–	–	**57,078**
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	**119,024**	–	–	**119,024**
Trading assets	**493,670**	–	–	–	–	–	–	–	**493,670**
Financial assets designated at fair value	–	**40,553**	–	–	–	–	–	–	**40,553**
Derivatives	**447,645**	–	–	–	–	–	**140**	**6,138**	**453,923**
Advances to customers	–	–	–	**1,286,145**	–	–	–	–	**1,286,145**
Financial investments	–	–	**77,502**	–	**508,659**	–	–	–	**586,161**
Amounts due from group companies	**53,375**	**429**	–	–	–	**324,858**	–	–	**378,662**
Other assets	–	–	–	–	–	**66,139**	–	–	**66,139**
Total financial assets	**994,690**	**40,982**	**81,974**	**1,678,445**	**692,916**	**653,160**	**140**	**6,138**	**4,148,445**
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	**119,024**	–	–	**119,024**
Items in the course of transmission to other banks	–	–	–	–	–	**31,334**	–	–	**31,334**
Deposits by banks	–	–	–	–	–	**196,674**	–	–	**196,674**
Customer accounts	–	–	–	–	–	**2,576,084**	–	–	**2,576,084**
Trading liabilities	**210,587**	–	–	–	–	–	–	–	**210,587**
Financial liabilities designated at fair value	–	**39,926**	–	–	–	–	–	–	**39,926**
Derivatives	**463,488**	–	–	–	–	–	**2,332**	**384**	**466,204**
Debt securities in issue	–	–	–	–	–	**48,800**	–	–	**48,800**
Amounts due to group companies	**19,479**	–	–	–	–	**31,765**	–	–	**51,244**
Other liabilities	–	–	–	–	–	**59,685**	–	–	**59,685**
Subordinated liabilities	–	–	–	–	–	**19,184**	–	–	**19,184**
Preference shares	–	–	–	–	–	**92,870**	–	–	**92,870**
Total financial liabilities	**693,554**	**39,926**	–	–	–	**3,175,420**	**2,332**	**384**	**3,911,616**

Notes on the Financial Statements (continued)

9 Financial Assets and Liabilities *(continued)*

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)*

Bank

	At 31 December 2008								
	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	–	–	–	**238,540**	**117,998**	**125,164**	–	–	**481,702**
Items in the course of collection from other banks	–	–	–	–	–	**9,908**	–	–	**9,908**
Placings with banks maturing after one month	–	–	–	**33,754**	–	–	–	–	**33,754**
Certificates of deposit	–	–	–	–	**36,980**	–	–	–	**36,980**
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	**119,024**	–	–	**119,024**
Trading assets	**329,123**	–	–	–	–	–	–	–	**329,123**
Financial assets designated at fair value	–	**1,728**	–	–	–	–	–	–	**1,728**
Derivatives	**447,586**	–	–	–	–	–	**140**	**4,483**	**452,209**
Advances to customers	–	–	–	**817,996**	–	–	–	–	**817,996**
Financial investments	–	–	–	–	**340,800**	–	–	–	**340,800**
Amounts due from group companies	**56,979**	–	–	–	–	**340,982**	–	–	**397,961**
Other assets	–	–	–	–	–	**42,455**	–	–	**42,455**
Total financial assets	**833,688**	**1,728**	–	**1,090,290**	**495,778**	**637,533**	**140**	**4,483**	**3,063,640**
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	**119,024**	–	–	**119,024**
Items in the course of transmission to other banks	–	–	–	–	–	**26,581**	–	–	**26,581**
Deposits by banks	–	–	–	–	–	**174,532**	–	–	**174,532**
Customer accounts	–	–	–	–	–	**1,767,001**	–	–	**1,767,001**
Trading liabilities	**151,089**	–	–	–	–	–	–	–	**151,089**
Financial liabilities designated at fair value	–	**7,086**	–	–	–	–	–	–	**7,086**
Derivatives	**455,932**	–	–	–	–	–	**1,727**	**73**	**457,732**
Debt securities in issue	–	–	–	–	–	**34,855**	–	–	**34,855**
Amounts due to group companies	**34,540**	–	–	–	–	**83,141**	–	–	**117,681**
Other liabilities	–	–	–	–	–	**45,592**	–	–	**45,592**
Subordinated liabilities	–	–	–	–	–	**10,602**	–	–	**10,602**
Preference shares	–	–	–	–	–	**92,870**	–	–	**92,870**
Total financial liabilities	**641,561**	**7,086**	–	–	–	**2,354,198**	**1,727**	**73**	**3,004,645**

Notes on the Financial Statements (continued)

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

10 Cash and short-term funds

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Cash in hand	**10,864**	9,501	**6,861**	6,259
Sight balances with central banks	**118,326**	3,328	**118,303**	2,721
Placings with banks with remaining maturity of one month or less	**336,731**	618,214	**238,540**	468,052
Treasury bills and other eligible bills	**131,651**	163,880	**117,998**	160,739
	597,572	794,923	**481,702**	637,771

As at 31 December 2008, included within notes 10 and 11, total amount placed with central banks, including sight balances, made by the Group amounting to HK$234,582 million (*2007: HK$88,469 million*). Placing with central banks made by the Bank amounted to HK$205,125 million (*2007: HK$57,447 million*).

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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Balances with banks and central banks	**37,397**	31,451	**22,290**	21,011
Treasury bills and other eligible bills	**848**	1,792	**746**	1,711
	38,245	33,243	**23,036**	22,722

Treasury bills and other eligible bills are analysed as follows:

	Group		*Bank*	
	2008	2007	**2008**	2007
	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	**1,041**	–	**–**	–
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**130,610**	163,880	**117,998**	160,739
	131,651	163,880	**117,998**	160,739

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 maturing after one month

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Gross placings with banks maturing after one month but less than one year	**51,763**	56,640	**30,508**	36,863
Gross placings with banks maturing after one year	**3,806**	3,688	**3,246**	2,979
Total placings with banks	**55,569**	60,328	**33,754**	39,842

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

12 Certificates of deposit

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Held-to-maturity	**4,472**	2,887	**–**	–
Available-for-sale	**52,606**	94,471	**36,980**	48,788
	57,078	97,358	**36,980**	48,788

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	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Trading assets				
– which may be repledged or resold by counterparties	**232**	13,659	**232**	580
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**493,438**	347,045	**328,891**	259,527
	493,670	360,704	**329,123**	260,107

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**187,236**	173,067	**147,381**	106,670
Equity shares	**12,012**	33,561	**11,282**	32,315
Treasury bills and other eligible bills	**238,778**	108,888	**125,644**	102,169
Other	**55,644**	45,188	**44,816**	18,953
	493,670	360,704	**329,123**	260,107

All treasury bills and other eligible bills are unlisted.

a *Debt securities*

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**23,848**	24,076	**20,217**	21,512
– listed outside Hong Kong	**11,648**	39,181	**11,208**	17,619
	35,496	63,257	**31,425**	39,131
Unlisted	**151,740**	109,810	**115,956**	67,539
	187,236	173,067	**147,381**	106,670
Issued by public bodies				
– central governments and central banks	**83,044**	102,920	**54,909**	55,593
– other public sector entities	**2,309**	3,046	**1,929**	2,652
	85,353	105,966	**56,838**	58,245
Issued by other bodies				
– banks	**86,780**	34,201	**76,969**	18,500
– corporate entities	**15,103**	32,900	**13,574**	29,925
	187,236	173,067	**147,381**	106,670

Notes on the Financial Statements (continued)

14 Trading assets *(continued)*

b *Equity shares*

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**2,461**	22,832	**2,461**	22,830
– listed outside Hong Kong	**4,573**	3,552	**4,573**	3,552
	7,034	26,384	**7,034**	26,382
Unlisted	**4,978**	7,177	**4,248**	5,933
	12,012	33,561	**11,282**	32,315
Issued by other bodies				
– banks	**1,634**	3,636	**1,634**	3,636
– corporate entities	**10,378**	29,925	**9,648**	28,679
	12,012	33,561	**11,282**	32,315

15 Financial assets designated at fair value

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**19,730**	19,589	**1,722**	2,843
Equity shares	**20,817**	43,545	**–**	–
Other	**6**	18	**6**	18
	40,553	63,152	**1,728**	2,861

a *Debt securities*

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**2,331**	2,983	**696**	778
– listed outside Hong Kong	**3,096**	5,294	**505**	1,351
	5,427	8,277	**1,201**	2,129
Unlisted	**14,303**	11,312	**521**	714
	19,730	19,589	**1,722**	2,843

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**4,505**	6,396	**571**	851
– other public sector entities	**2,020**	1,611	**434**	267
	6,525	8,007	**1,005**	1,118
Issued by other bodies				
– banks	**9,543**	7,197	**–**	76
– corporate entities	**3,662**	4,385	**717**	1,649
	19,730	19,589	**1,722**	2,843

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

b *Equity shares*

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**2,399**	9,140	**–**	–
– listed outside Hong Kong	**8,315**	14,587	**–**	–
	10,714	23,727	**–**	–
Unlisted	**10,103**	19,818	**–**	–
	20,817	43,545	**–**	–
Issued by other bodies[1]				
– banks	**758**	2,044	**–**	–
– corporate entities	**20,059**	41,501	**–**	–
	20,817	43,545	**–**	–

1 *The comparatives have been restated in respect of the split between banks and corporates to be consistent with the current year's presentation.*

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.

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

Notes on the Financial Statements (continued)

16 Derivatives *(continued)*

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

	2008		2007	
	Group	*Bank*	*Group*	*Bank*
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**6,462,356**	**5,961,152**	7,357,202	6,728,698
Interest rate	**9,614,270**	**9,476,072**	10,651,066	10,573,561
Equities	**313,779**	**325,712**	312,162	301,807
Credit derivatives	**778,795**	**778,795**	709,173	707,737
Commodity and other	**26,355**	**23,672**	15,724	14,287
Total derivatives	**17,195,555**	**16,565,403**	19,045,327	18,326,090

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

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

	2008		2007	
	Group	*Bank*	*Group*	*Bank*
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**611**	**611**	1,533	1,514
Interest rate	**7,853**	**6,050**	4,612	3,403
Equities	**771**	**723**	3,034	768
Credit derivatives	**–**	**–**	–	–
Commodity and other	**–**	**–**	–	–
Total derivatives	**9,235**	**7,384**	9,179	5,685

16 Derivatives *(continued)*

(ii) Fair values of outstanding trading derivatives

Group

	2008		2007	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**185,271**	**193,979**	72,322	71,903
Interest rate	**197,443**	**191,906**	73,778	71,522
Equities	**28,374**	**41,696**	21,197	23,902
Credit derivatives	**35,470**	**34,357**	6,588	4,602
Commodity and other	**1,087**	**1,550**	99	427
Total derivatives	**447,645**	**463,488**	173,984	172,356

Bank

	2008		2007	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**182,235**	**188,409**	70,577	70,299
Interest rate	**195,014**	**189,348**	73,636	71,193
Equities	**34,645**	**41,577**	22,118	23,669
Credit derivatives	**34,918**	**34,356**	6,544	4,600
Commodity and other	**774**	**2,242**	318	426
Total derivatives	**447,586**	**455,932**	173,193	170,187

(iii) Risk exposure by counterparty type

	2008		2007	
	Group	*Bank*	*Group*	*Bank*
	%	%	%	%
Government	–	–	1	1
Banks	**76**	**77**	75	75
Other financial institutions	**8**	**8**	11	11
Other	**16**	**15**	13	13
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.

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

	Group		*Bank*	
	Cash flow hedge	**Fair value hedge**	**Cash flow hedge**	**Fair value hedge**
	HK$m	**HK$m**	**HK$m**	**HK$m**
31 December 2008				
Interest rate	**310,883**	**62,482**	**216,633**	**47,201**
Total derivatives	**310,883**	**62,482**	**216,633**	**47,201**

Notes on the Financial Statements (continued)

16 Derivatives *(continued)*

	Group		*Bank*	
	Cash flow hedge HK$m	Fair value hedge HK$m	Cash flow hedge HK$m	Fair value hedge HK$m
31 December 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

(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 2008				
Interest rate	**140**	**2,332**	**140**	**1,727**

	Group		*Bank*	
	Assets HK$m	Liabilities HK$m	Assets HK$m	Liabilities HK$m
31 December 2007				
Interest rate	331	586	241	461

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

	Group		*Bank*	
	Assets	**Liabilities**	**Assets**	**Liabilities**
31 December 2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Interest rate	**6,138**	**384**	**4,483**	**73**
	6,138	**384**	**4,483**	**73**

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

The cash flows of the above hedging derivatives are expected to affect the income statement in 2009 and beyond.

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 2008, a loss of HK$50 million *(2007: HK$2 million)* was recognised due to hedge ineffectiveness and termination of forecast transactions.

16 Derivatives *(continued)*

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2008 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 2008			
Cash inflows from assets	**242,720**	**139,768**	**34,906**
Cash outflows from liabilities	**(6,888)**	**(6,888)**	**(4,665)**
Net cash inflows	**235,832**	**132,880**	**30,241**
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 inflow	297,861	184,157	6,247

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

	2008 HK$m	2007 HK$m
Balance at 1 January	**496**	108
Deferrals on new transactions	**403**	975
Reduction due to amortisation	**(565)**	(166)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(194)**	(420)
Exchange differences and others	**(21)**	(1)
Balance at 31 December	**119**	496

Bank

	2008 HK$m	2007 HK$m
Balance at 1 January	**498**	110
Deferrals on new transactions	**377**	975
Reduction due to amortisation	**(565)**	(166)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(168)**	(420)
Exchange differences and others	**(23)**	(1)
Balance at 31 December	**119**	498

Notes on the Financial Statements (continued)

17 Advances to customers

a *Advances to customers*

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers	**1,297,103**	1,219,346	**826,288**	749,254
Impairment allowances (note 18a)	**(10,958)**	(7,260)	**(8,292)**	(5,724)
	1,286,145	1,212,086	**817,996**	743,530

Included in advances to customers are:

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Trade bills	**59,820**	66,518	**51,870**	54,470
Individually assessed impairment allowances	**(329)**	(160)	**(286)**	(153)
	59,491	66,358	**51,584**	54,317

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

2008	*Hong Kong*	*Rest of Asia-Pacific*	*Americas/ Europe*	*Total*
	HK$m	HK$m	HK$m	HK$m
Residential mortgages	**223,066**	**118,733**	**4**	**341,803**
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**30,086**	–	–	**30,086**
Credit card advances	**36,255**	**25,120**	–	**61,375**
Other personal	**41,267**	**37,255**	–	**78,522**
Total personal	**330,674**	**181,108**	**4**	**511,786**
Commercial, industrial and international trade	**156,438**	**203,259**	–	**359,697**
Commercial real estate	**109,266**	**50,787**	–	**160,053**
Other property-related lending	**78,757**	**21,653**	–	**100,410**
Government	**7,367**	**4,386**	–	**11,753**
Other commercial	**50,540**	**52,607**	–	**103,147**
Total corporate and commercial	**402,368**	**332,692**	–	**735,060**
Non-bank financial institutions	**18,617**	**29,870**	–	**48,487**
Settlement accounts	**1,651**	**119**	–	**1,770**
Total financial	**20,268**	**29,989**	–	**50,257**
Gross advances to customers	**753,310**	**543,789**	**4**	**1,297,103**
Individually assessed impairment allowances	**(3,108)**	**(1,925)**	–	**(5,033)**
Collectively assessed impairment allowances	**(2,460)**	**(3,465)**	–	**(5,925)**
Net advances to customers	**747,742**	**538,399**	**4**	**1,286,145**

17 Advances to customers *(continued)*

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

Bank

2008	*Hong Kong*	*Rest of Asia-Pacific*	*Americas/ Europe*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Residential mortgages	**120,158**	**80,694**	**–**	**200,852**
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**13,346**	–	**–**	**13,346**
Credit card advances	**23,414**	**20,745**	**–**	**44,159**
Other personal	**25,119**	**32,238**	**–**	**57,357**
Total personal	**182,037**	**133,677**	**–**	**315,714**
Commercial, industrial and international trade	**108,378**	**133,453**	**–**	**241,831**
Commercial real estate	**79,937**	**28,281**	**–**	**108,218**
Other property-related lending	**21,734**	**13,750**	**–**	**35,484**
Government	**6,706**	**3,722**	**–**	**10,428**
Other commercial	**32,562**	**39,205**	**–**	**71,767**
Total corporate and commercial	**249,317**	**218,411**	**–**	**467,728**
Non-bank financial institutions	**15,458**	**27,385**	**–**	**42,843**
Settlement accounts	**–**	**3**	**–**	**3**
Total financial	**15,458**	**27,388**	**–**	**42,846**
Gross advances to customers	**446,812**	**379,476**	**–**	**826,288**
Individually assessed impairment allowances	**(2,038)**	**(1,578)**	**–**	**(3,616)**
Collectively assessed impairment allowances	**(1,757)**	**(2,919)**	**–**	**(4,676)**
Net advances to customers	**443,017**	**374,979**	**–**	**817,996**

Notes on the Financial Statements (continued)

17 Advances to customers *(continued)*

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

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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial				
Property development	**55,646**	47,217	**15,280**	12,198
Property investment	**139,174**	116,331	**108,386**	86,658
Financial concerns	**9,417**	10,731	**3,071**	1,588
Stockbrokers	**744**	2,669	**308**	544
Wholesale and retail trade	**51,580**	38,502	**16,828**	12,164
Manufacturing	**31,811**	21,526	**5,927**	4,424
Transport and transport equipment	**29,026**	26,381	**17,552**	18,388
Recreational activities	**55**	238	**28**	12
Information technology	**4,189**	2,504	**75**	27
Others	**49,562**	40,674	**12,555**	14,864
	371,204	306,773	**180,010**	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	**30,086**	30,738	**29,777**	30,686
Advances for the purchase of other residential properties	**198,982**	176,591	**197,547**	176,123
Credit card advances	**36,255**	35,279	**–**	–
Others	**34,232**	37,188	**11,628**	16,078
	299,555	279,796	**238,952**	222,887
Gross advances to customers for use in Hong Kong	**670,759**	586,569	**418,962**	373,754
Trade finance	**64,758**	65,149	**21,965**	22,007
Gross advances to customers for use outside Hong Kong made by branches of the Bank and subsidiary companies in Hong Kong	**17,793**	16,471	**3,005**	2,639
Gross advances to customers made by branches of the Bank and subsidiary companies in Hong Kong	**753,310**	668,189	**443,932**	398,400
Gross advances to customers made by branches of the Bank and subsidiary companies outside Hong Kong				
– Rest of Asia-Pacific	**543,789**	551,152	**221,776**	217,710
– Americas/Europe	**4**	5	**–**	–
Gross advances to customers	**1,297,103**	1,219,346	**665,708**	616,110

Notes on the Financial Statements (continued)

17 Advances to customers *(continued)*

	Bank			
	Gross Advances		*Collateral and other security*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial				
Property development	**30,332**	26,248	**7,000**	4,958
Property investment	**72,985**	61,629	**50,554**	40,531
Financial concerns	**6,231**	7,225	**1,162**	939
Stockbrokers	**218**	2,145	**102**	115
Wholesale and retail trade	**45,594**	32,293	**13,468**	9,330
Manufacturing	**18,067**	12,941	**2,450**	1,919
Transport and transport equipment	**20,604**	16,960	**10,958**	11,787
Recreational activities	**29**	20	**11**	9
Information technology	**3,114**	1,591	**26**	6
Others	**27,375**	18,312	**3,473**	3,715
	224,549	179,364	**89,204**	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	**13,346**	12,301	**13,056**	12,278
Advances for the purchase of other residential properties	**109,313**	90,668	**108,417**	90,558
Credit card advances	**23,414**	23,924	**–**	–
Others	**21,580**	21,191	**6,972**	9,243
	167,653	148,084	**128,445**	112,079
Gross advances to customers for use in Hong Kong	**392,202**	327,448	**217,649**	185,388
Trade finance	**45,719**	42,154	**14,069**	14,493
Gross advances to customers for use outside Hong Kong made by branches of the Bank in Hong Kong	**8,891**	9,995	**147**	1,053
Gross advances to customers made by branches of the Bank in Hong Kong	**446,812**	379,597	**231,865**	200,934
Gross advances to customers made by branches of the Bank outside Hong Kong				
– rest of Asia-Pacific	**379,476**	369,656	**147,747**	139,645
– Americas/Europe	**–**	1	**–**	–
Gross advances to customers	**826,288**	749,254	**379,612**	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)*

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 has been included.

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

Group

	2008			2007		
	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	**3,570**	**720**	**4,290**	5,232	1,237	6,469
– After one year but within five years	**8,825**	**1,640**	**10,465**	10,471	2,880	13,351
– After five years	**10,330**	**1,695**	**12,025**	11,534	3,758	15,292
	22,725	**4,055**	**26,780**	27,237	7,875	35,112
Impairment allowances	**(46)**			(49)		
Net investment in finance leases and hire purchase contracts	**22,679**			27,188		

Bank

	2008			2007		
	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	**2,253**	**337**	**2,590**	3,697	696	4,393
– After one year but within five years	**5,197**	**793**	**5,990**	6,999	1,579	8,578
– After five years	**5,273**	**814**	**6,087**	6,238	1,778	8,016
	12,723	**1,944**	**14,667**	16,934	4,053	20,987
Impairment allowances	**(15)**			(13)		
Net investment in finance leases and hire purchase contracts	**12,708**			16,921		

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*
2008	**HK$m**	**HK$m**	**HK$m**
At 1 January	**2,182**	**5,078**	**7,260**
Amounts written off	**(628)**	**(5,920)**	**(6,548)**
Recoveries of advances written off in previous years	**169**	**823**	**992**
Net charge to income statement (note 5l)	**3,551**	**6,542**	**10,093**
Unwinding of discount of loan impairment	**(69)**	**(211)**	**(280)**
Exchange and other adjustments	**(172)**	**(387)**	**(559)**
At 31 December (note 17a)	**5,033**	**5,925**	**10,958**

	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 (note 17a)	2,182	5,078	7,260

Bank

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2008	**HK$m**	**HK$m**	**HK$m**
At 1 January	**1,657**	**4,067**	**5,724**
Amounts written off	**(446)**	**(5,132)**	**(5,578)**
Recoveries of advances written off in previous years	**113**	**716**	**829**
Net charge to income statement	**2,571**	**5,577**	**8,148**
Unwinding of discount of loan impairment	**(56)**	**(211)**	**(267)**
Exchange and other adjustments	**(223)**	**(341)**	**(564)**
At 31 December (note 17a)	**3,616**	**4,676**	**8,292**

	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 (note 17a)	1,657	4,067	5,724

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

b *Impaired advances to customers and allowances*

Group

2008	*Hong Kong* **HK$m**	*Rest of Asia-Pacific* **HK$m**	*Total* **HK$m**
Impairment allowance charge	**4,210**	**5,883**	**10,093**
Advances to customers which are considered to be impaired are as follows:–			
Gross impaired advances[1]	**6,601**	**6,479**	**13,080**
Individually assessed allowances	**(3,108)**	**(1,925)**	**(5,033)**
	3,493	**4,554**	**8,047**
Individually assessed allowances as a percentage of gross impaired advances	**47.1%**	**29.7%**	**38.5%**
Gross impaired advances as a percentage of gross advances to customers	**0.9%**	**1.2%**	**1.0%**

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[1]	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%

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

Notes on the Financial Statements (continued)

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

Bank

2008	*Hong Kong* **HK$m**	*Rest of Asia-Pacific* **HK$m**	*Total* **HK$m**
Impairment allowance charge	**3,038**	**5,110**	**8,148**
Advances to customers which are considered to be impaired are as follows:–			
Gross impaired advances[1]	**4,081**	**4,637**	**8,718**
Individually assessed allowances	**(2,038)**	**(1,578)**	**(3,616)**
	2,043	**3,059**	**5,102**
Individually assessed allowances as a percentage of gross impaired advances	**49.9%**	**34.0%**	**41.5%**
Gross impaired advances as a percentage of gross advances to customers	**0.9%**	**1.2%**	**1.1%**

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[1]	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%

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

Impaired advances to customers are those advances where objective evidence exists that full repayment of principal or interest is considered unlikely.

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

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 2008			
Gross individually assessed impaired advances	**6,295**	**5,050**	**11,345**
Individually assessed impairment allowances	**(3,108)**	**(1,925)**	**(5,033)**
	3,187	**3,125**	**6,312**
Gross individually assessed impaired advances as a percentage of gross advances to customers	**0.8%**	**0.9%**	**0.9%**
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**3,243**	**2,988**	**6,231**
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%
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	1,973	1,406	3,379

Bank	*Hong Kong*	*Rest of Asia-Pacific*	*Total*
	HK$m	**HK$m**	**HK$m**
31 December 2008			
Gross individually assessed impaired advances	**3,883**	**3,365**	**7,248**
Individually assessed impairment allowances	**(2,038)**	**(1,578)**	**(3,616)**
	1,845	**1,787**	**3,632**
Gross individually assessed impaired advances as a percentage of gross advances to customers	**0.9%**	**0.9%**	**0.9%**
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**1,721**	**1,879**	**3,600**

Notes on the Financial Statements (continued)

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

31 December 2007	*Hong Kong* HK$m	*Rest of Asia-Pacific* HK$m	*Total* HK$m
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%
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	1,293	1,075	2,368

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 *Figures in HK$m*	*Total gross advances*	*Gross impaired advances*	*Individually assessed allowances*	*Collectively assessed allowances*	*Net new impairment allowances*	*Advances written-off in year*
At 31 December 2008						
Residential mortgages	**341,803**	**2,590**	**(191)**	**(311)**	**106**	**43**
Commercial, industrial and international trade	**359,697**	**6,137**	**(3,821)**	**(2,185)**	**3,464**	**360**
Commercial real estate	**160,053**	**255**	**(105)**	**(83)**	**127**	**22**
At 31 December 2007						
Residential mortgages	326,366	2,066	(204)	(275)	(36)	84
Commercial, industrial and international trade	338,806	2,538	(1,617)	(1,553)	1,085	932
Commercial real estate	141,139	84	(11)	(54)	(29)	28

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

Bank *Figures in HK$m*	*Total gross advances*	*Gross impaired advances*	*Individually assessed allowances*	*Collectively assessed allowances*	*Net new impairment allowances*	*Advances written-off in year*
At 31 December 2008						
Residential mortgages	**200,852**	**1,545**	**(152)**	**(205)**	**88**	**35**
Commercial, industrial and international trade	**241,831**	**3,961**	**(2,712)**	**(1,511)**	**2,470**	**244**
Commercial real estate	**108,218**	**204**	**(105)**	**(75)**	**126**	**19**
At 31 December 2007						
Residential mortgages	187,539	1,456	(156)	(178)	(29)	73
Commercial, industrial and international trade	220,481	1,757	(1,199)	(1,071)	798	727
Commercial real estate	89,645	63	(11)	(47)	(26)	27

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*	
2008	**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	**1,059**	**0.1**	**2,559**	**0.5**	**3,618**	**0.3**
– more than six months but not more than one year	**603**	**0.1**	**859**	**0.2**	**1,462**	**0.1**
– more than one year	**881**	**0.1**	**1,613**	**0.3**	**2,494**	**0.2**
	2,543	**0.3**	**5,031**	**1.0**	**7,574**	**0.6**
Individually assessed impairment allowances made in respect of such overdue advances	**(809)**		**(1,088)**		**(1,897)**	
Fair value of collateral held in respect of overdue advances	**1,293**		**1,805**		**3,098**	

Notes on the Financial Statements (continued)

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

2007	*Hong Kong* HK$m	*Hong Kong* %	*Rest of Asia-Pacific* HK$m	*Rest of Asia-Pacific* %	*Total* HK$m	*Total* %
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)	
Fair value of collateral held in respect of overdue advances	1,118		1,266		2,384	

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

Bank

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
2008	**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	**827**	**0.2**	**1,773**	**0.5**	**2,600**	**0.3**
– more than six months but not more than one year	**206**	**0.0**	**591**	**0.2**	**797**	**0.1**
– more than one year	**779**	**0.2**	**1,159**	**0.3**	**1,938**	**0.2**
	1,812	**0.4**	**3,523**	**1.0**	**5,335**	**0.6**
Individually assessed impairment allowances made in respect of such overdue advances	**(303)**		**(939)**		**(1,242)**	
Fair value of collateral held in respect of overdue advances	**848**		**1,141**		**1,989**	

Notes on the Financial Statements (continued)

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

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)	
Fair value of collateral held in respect of overdue advances	717		781		1,498	

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

e *Rescheduled advances to customers*

Group

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
	HK$m	**%**	**HK$m**	**%**	**HK$m**	**%**
2008	**1,688**	**0.2**	**1,472**	**0.3**	**3,160**	**0.2**
2007	1,610	0.2	1,620	0.3	3,230	0.3

Bank

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
	HK$m	**%**	**HK$m**	**%**	**HK$m**	**%**
2008	**1,406**	**0.3**	**1,377**	**0.4**	**2,783**	**0.3**
2007	1,258	0.3	1,521	0.4	2,779	0.4

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 or rescheduled advances to banks or overdue or rescheduled other assets as at 31 December 2008 and 31 December 2007. Information relating to overdue balances can be found in note 52.

Notes on the Financial Statements (continued)

20 Financial investments

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Financial investments				
– which may be repledged or resold by counterparties	**1,443**	5,637	**1,173**	4,380
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**584,718**	526,606	**339,627**	249,845
	586,161	532,243	**340,800**	254,225

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Debt securities				
– available-for-sale	**472,018**	404,992	**311,412**	189,023
– held-to-maturity	**77,502**	45,243	**–**	–
Equity shares				
– available-for-sale	**36,641**	82,008	**29,388**	65,202
	586,161	532,243	**340,800**	254,225

a *Held-to-maturity debt securities*

Group

	Book value		Fair value	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**3,533**	367	**3,860**	377
– listed outside Hong Kong	**10,144**	3,085	**10,925**	3,203
	13,677	3,452	**14,785**	3,580
Unlisted	**63,825**	41,791	**69,241**	42,879
	77,502	45,243	**84,026**	46,459

	Book value		Fair value	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**2,032**	1,436	**2,281**	1,506
– other public sector entities	**5,831**	1,889	**6,270**	1,980
	7,863	3,325	**8,551**	3,486
Issued by other bodies				
– banks	**59,804**	39,910	**64,725**	40,930
– corporate entities	**9,835**	2,008	**10,750**	2,043
	77,502	45,243	**84,026**	46,459

20 Financial investments *(continued)*

b *Available-for-sale debt securities*

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**5,841**	7,023	**2,163**	2,487
– listed outside Hong Kong	**212,380**	115,048	**149,743**	44,973
	218,221	122,071	**151,906**	47,460
Unlisted	**253,797**	282,921	**159,506**	141,563
	472,018	404,992	**311,412**	189,023

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**109,354**	59,412	**76,018**	38,295
– other public sector entities	**8,208**	13,075	**6,107**	8,024
	117,562	72,487	**82,125**	46,319
Issued by other bodies				
– banks	**318,623**	300,975	**205,466**	125,336
– corporate entities	**35,833**	31,530	**23,821**	17,368
	472,018	404,992	**311,412**	189,023

c *Available-for-sale equity shares*

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**23,898**	57,606	**23,056**	51,451
– listed outside Hong Kong	**1,214**	1,627	**961**	1,218
	25,112	59,233	**24,017**	52,669
Unlisted	**11,529**	22,775	**5,371**	12,533
	36,641	82,008	**29,388**	65,202

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Issued by other bodies				
– banks	**6,629**	11,843	**3,997**	6,873
– corporate entities	**30,012**	70,165	**25,391**	58,329
	36,641	82,008	**29,388**	65,202

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 2008 and 2007, and their associated financial liabilities:

	2008		2007	
	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	**2,353**	**2,351**	1,895	1,843
Securities lending agreements	**363**	**8**	17,400	13,132
	2,716	**2,359**	19,295	14,975

22 Investments in subsidiary companies

	Bank 2008 HK$m	2007 HK$m
Investment in subsidiary companies		
Unlisted investments	**16,091**	15,509
Listed investment	**865**	865
	16,956	16,374

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 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.

Acquisitions

HSBC made the following acquisitions of subsidiaries or business operations in 2008, which were accounted for using the purchase method:

On 29 March 2008, the group acquired the assets, liabilities and operations of The Chinese Bank Co., Ltd. ('The Chinese Bank') in Taiwan. The group recognised goodwill of HK$33 million and received a payment of HK$12,274 million from the Taiwan Government's Central Deposit Insurance Corporation. Since the date of acquisition, The Chinese Bank has contributed a loss of HK$45 million to the net profit of the group.

Notes on the Financial Statements (continued)

22 Investments in subsidiary companies *(continued)*

The following table sets out the amounts recognised by the group, as at the date of acquisition, in respect of the assets and liabilities acquired. As The Chinese Bank did not prepare accounts under HKFRS, it is impracticable to determine what the carrying amounts of the assets and liabilities would have been under HKFRS immediately prior to the acquisition.

	Fair Value HK$m
At date of acquisition	
Cash and balances at central banks	**290**
Loans and advances to banks	**1,427**
Loans and advances to customers	**10,776**
Trading assets	**1,013**
Intangibles	**2,084**
Fixed assets	**308**
Prepayments and accrued income	**12**
Other assets	**1,498**
Deposits by banks	**(7,993)**
Customer deposits	**(19,567)**
Debt securities in issue	**(1,641)**
Accruals and deferred income	**(165)**
Other liabilities and provisions	**(349)**
Net liabilities acquired	**(12,307)**
Goodwill	**33**
Total cash received	**(12,274)**

On 29 September 2008, HSBC acquired 93.86 per cent of IL&FS Investsmart Limited ('Investsmart') in India. The Hongkong and Shanghai Banking Corporation Limited ('the group') holds 43.85 per cent and accounts for the acquisition as a subsidiary undertaking. The group paid a cash consideration of HK$1,142 million in respect of this acquisition. The group recognised goodwill and intangible assets of HK$572 million.

The group has less than 50 per cent of the voting rights of Investsmart however, the entity is consolidated as the group has management control over Investsmart by the existence of presently exercisable potential voting rights.

23 Investments in associates and joint ventures

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Unlisted investments	–	–	**1,751**	1,080
Listed investment	–	–	**19,381**	19,381
Share of net assets	**41,007**	33,952	–	–
Goodwill	**4,895**	3,837	–	–
Intangible assets	**3,115**	2,789	–	–
Deferred tax on intangible assets	**(747)**	(746)	–	–
	48,270	39,832	**21,132**	20,461

At 31 December 2008, the group's investments in associates amounted to HK$47,343 million (*2007: HK$38,922 million*).

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 3,642bn	20.00%

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

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

Shareholdings in associated companies include listed investments of HK$19,381 million *(2007: HK$19,381 million)*. At the balance sheet date, the fair value of these investments, based on quoted market prices was HK$62,653 million *(2007: HK$136,700 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, the group is assisting in the development of financial and operating policies. In respect of Bank of Communications Co., Ltd, a number of staff have been seconded to assist in this process.

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

Notes on the Financial Statements (continued)

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

In respect of the year ended 31 December 2008, 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 2008, but taking into account any changes in the subsequent period from 1 October 2008 to 31 December 2008 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% in December 2007 as a result of a rights issue in which the group did not participate. In September 2008, the group increased its equity interest to 20%.

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

	Assets	*Liabilities*	*Equity*	*Revenue*	*Expenses*	*Profit*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
2008						
100 per cent	**3,959,659**	**3,731,484**	**228,175**	**121,352**	**75,068**	**46,284**
Group's effective interest[1]	**637,237**	**599,380**	**37,857**	**19,831**	**12,507**	**7,324**
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

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

At 31 December 2008, the group's share of associates and joint ventures' contingent liabilities was HK$127,650 million *(2007: HK$99,619 million)*.

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

c *Movement in investments in associates and joint ventures*

	2008	
	Group	*Bank*
	HK$m	**HK$m**
At 1 January	**39,832**	**20,461**
Additions	**2,577**	**671**
Disposals	**(823)**	–
Retained profits	**4,987**	–
Amortisation of intangible assets (net of deferred tax)	**(322)**	–
Exchange and other movements	**2,019**	–
At 31 December	**48,270**	**21,132**

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

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

Group	**2008**		2007	
	Highest balance during the year [1]	**Balance at 31 December [1]**	Highest balance during the year [1]	Balance at 31 December [1]
	HK$m	**HK$m**	HK$m	HK$m
Amounts due from associates – unsubordinated	**7,781**	**1,752**	54,826	4,335
Amounts due from joint ventures – unsubordinated	**1,242**	**904**	995	995
Amounts due to associates	**5,445**	**2,211**	39,439	1,864
Amounts due to joint ventures	**359**	**357**	340	14

Bank	**2008**		2007	
	Highest balance during the year [1]	**Balance at 31 December [1]**	Highest balance during the year [1]	Balance at 31 December [1]
	HK$m	**HK$m**	HK$m	HK$m
Amounts due from associates – unsubordinated	**3,247**	**139**	32,485	963
Amounts due from joint ventures – unsubordinated	**1,242**	**904**	995	995
Amounts due to associates	**1,118**	**632**	14,803	898
Amounts due to joint ventures	**359**	**357**	340	14

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.

Notes on the Financial Statements (continued)

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

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 2008, the company was equity accounted for based on financial statements made up to 30 November 2008, taking into account changes in the subsequent period from 1 December to 31 December 2008 that would have materially affected its results.

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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Goodwill	**2,523**	2,158	**1,020**	1,063
The present value of in-force long-term assurance business	**7,638**	6,824	**–**	–
Other intangible assets	**6,020**	3,327	**5,348**	2,964
	16,181	12,309	**6,368**	4,027

a *Goodwill*

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Cost				
At 1 January	**2,158**	1,997	**1,063**	1,021
Additions	**552**	50	**9**	1
Reclassified as held for sale	**–**	(6)	**–**	(6)
Exchange and other movements	**(187)**	117	**(52)**	47
At 31 December	**2,523**	2,158	**1,020**	1,063
Net book value at 31 December	**2,523**	2,158	**1,020**	1,063

24 Goodwill and intangible assets *(continued)*

Segmental analysis of goodwill

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong – Personal Financial Services	**12**	12	**–**	–
Hong Kong – Commercial Banking	**36**	36	**24**	24
Hong Kong – Global Banking and Markets	**754**	756	**498**	499
Rest of Asia-Pacific – Personal Financial Services	**895**	716	**59**	78
Rest of Asia-Pacific – Commercial Banking	**313**	106	**8**	–
Rest of Asia-Pacific – Global Banking and Markets	**513**	532	**431**	462
	2,523	2,158	**1,020**	1,063

During 2008 there was no impairment of goodwill (*2007: 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 2008 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 in which the CGU operates.

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

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.

If some or all of the goodwill allocated to a CGU was acquired in a business combination during the current annual period, that unit is tested for impairment before the end of the current annual period. As a result, goodwill was retested as at 1 October 2008. This testing confirmed that goodwill remained unimpaired.

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the nominal long-term growth rate. The discount rates used in the impairment test at 1 October 2008 were in the range of 9 per cent to 11 per cent across different CGUs. The nominal long-term growth rates used in the impairment test at 1 October 2008 for Hong Kong and Rest of Asia-Pacific were 5.1 per cent and 8.2 per cent respectively.

Notes on the Financial Statements (continued)

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 Hong Kong, being the main life insurance operations:

	2008	2007
Risk free rate	**1.14%**	3.51%
Risk adjusted discount rate	**11.0%**	11.0%
Expenses inflation	**3.0%**	3.0%
Lapse rate	**0%-15% for the first policy year and 0%-15% for renewal years**	1%-15% for the first policy year and 0%-15% for renewal years

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

	Group	
	2008	2007
	HK$m	HK$m
At 1 January	**6,824**	5,841
Addition from current year new business	**1,601**	1,582
Movement from in-force business	**(778)**	(632)
Exchange and other adjustments	**(9)**	33
At 31 December	**7,638**	6,824

c *Other intangible assets*

Group

	Computer software	*Customer/ merchant relationships*	*Other*[1]	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Cost				
At 1 January 2008	**3,749**	**1,208**	**11**	**4,968**
Additions	**1,700**	**30**	**2,186**	**3,916**
Disposals / amounts written-off	**(70)**	**–**	**(1)**	**(71)**
Exchange and other movements	**(39)**	**(226)**	**(163)**	**(428)**
At 31 December 2008	**5,340**	**1,012**	**2,033**	**8,385**
Accumulated amortisation and impairment				
At 1 January 2008	**1,449**	**189**	**3**	**1,641**
Amortisation charge for the year	**712**	**117**	**3**	**832**
Disposals / amounts written-off	**(65)**	**–**	**(1)**	**(66)**
Exchange and other movements	**(2)**	**(42)**	**2**	**(42)**
At 31 December 2008	**2,094**	**264**	**7**	**2,365**
Net book value at 31 December 2008	**3,246**	**748**	**2,026**	**6,020**

24 Goodwill and intangible assets *(continued)*

Group

	Computer software	*Customer/ merchant relationships*	*Other*	*Total*
	HK$m	HK$m	HK$m	HK$m
Cost				
At 1 January 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

Bank

	Computer software	*Customer/ merchant relationships*	*Other*[1]	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Cost				
At 1 January 2008	**3,297**	**1,120**	**3**	**4,420**
Additions	**1,370**	**2**	**2,090**	**3,462**
Disposals / amounts written-off	**(54)**	**–**	**–**	**(54)**
Exchange and other movements	**(11)**	**(226)**	**(169)**	**(406)**
At 31 December 2008	**4,602**	**896**	**1,924**	**7,422**
Accumulated amortisation and impairment				
At 1 January 2008	**1,294**	**159**	**3**	**1,456**
Amortisation charge for the year	**625**	**96**	**–**	**721**
Disposals / amounts written-off	**(54)**	**–**	**–**	**(54)**
Exchange and other movements	**(9)**	**(41)**	**1**	**(49)**
At 31 December 2008	**1,856**	**214**	**4**	**2,074**
Net book value at 31 December 2008	**2,746**	**682**	**1,920**	**5,348**

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

1 *'Other' includes branch operating rights of HK$2,084 million which were recognised during the acquisition of the assets, liabilities and operations of The Chinese Bank in Taiwan in 2008. These have an indefinite useful life as there are no economic or legal restrictions to limit their use. The carrying value of this intangible asset was allocated to relevant business units in Taiwan.*

The above intangible assets are amortised over their finite useful lives as follows:

Computer software	from 3 years to 5 years
Customer/merchant relationships	from 3 years to 12 years
Other (excluding branch operating rights)	from 3 years to 10 years

An impairment test was carried out in respect of the branch operating rights in Taiwan as at 31 December 2008. The result confirmed that there was no impairment. The impairment test was performed by comparing the recoverable amount of the relevant cash generating units ('CGUs') determined by a value in use calculation. The calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using an income growth rate applicable to the banking industry in Taiwan. The discount rate used is based on cost of capital the group allocates to Taiwan.

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

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

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs is the discount rate and the income growth rate. The discount rate and the income growth rate used in the impairment testing at 31 December 2008 were 11 per cent and 6.6 per cent respectively.

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 2008	**25,935**	**2,808**	**14,800**	**15,763**	**125**	**10,429**
Exchange and other adjustments	**(167)**	–	**(597)**	**(128)**	–	**(511)**
Additions	**432**	–	**3,160**	**424**	–	**2,189**
Disposals	**(21)**	–	**(978)**	**(21)**	–	**(610)**
Elimination of accumulated depreciation on revalued premises	**(804)**	–	–	**(528)**	–	–
Surplus on revaluation	**2,006**	**11**	–	**1,759**	–	–
Reclassifications	**(5)**	**5**	–	–	–	–
At 31 December 2008	**27,376**	**2,824**	**16,385**	**17,269**	**125**	**11,497**

	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 2008	**3**	–	**10,184**	–	–	**7,022**
Exchange and other adjustments	**(3)**	–	**(406)**	**(4)**	–	**(302)**
Charge for the year	**830**	–	**1,779**	**551**	–	**1,311**
Disposals	**(19)**	–	**(864)**	**(19)**	–	**(524)**
Elimination of accumulated depreciation on revalued premises	**(804)**	–	–	**(528)**	–	–
At 31 December 2008	**7**	–	**10,693**	–	–	**7,507**
Net book value at 31 December 2008	**27,369**	**2,824**	**5,692**	**17,269**	**125**	**3,990**
Total at 31 December 2008			**35,885**			**21,384**

Notes on the Financial Statements (continued)

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 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

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

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Cost less accumulated depreciation	**12,075**	12,109	**8,566**	8,531

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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Premises carried at valuation	**27,202**	25,771	**17,269**	15,763
Other premises stated at cost	**174**	164	**–**	–
Premises before deduction of accumulated depreciation	**27,376**	25,935	**17,269**	15,763

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

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Long leaseholds (over fifty years)	**10,254**	9,200	**6,795**	5,722
Medium-term leaseholds (between ten and fifty years)	**15,390**	15,151	**7,015**	6,746
Short leaseholds (less than ten years)	**111**	121	**111**	121
	25,755	24,472	**13,921**	12,589
Outside Hong Kong:				
Freeholds	**3,394**	3,209	**3,213**	3,010
Long leaseholds (over fifty years)	**92**	90	**61**	60
Medium-term leaseholds (between ten and fifty years)	**922**	936	**169**	196
Short leaseholds (less than ten years)	**30**	33	**30**	33
	4,438	4,268	**3,473**	3,299
	30,193	28,740	**17,394**	15,888
Analysed as follows:				
Premises	**27,369**	25,932	**17,269**	15,763
Investment properties	**2,824**	2,808	**125**	125
	30,193	28,740	**17,394**	15,888

The group's premises and investment properties were revalued at 31 October 2008 and updated for any material changes at 31 December 2008. 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$9,034 million *(2007: HK$7,691 million)* in respect of properties which were valued using the depreciated replacement cost method.

The surplus on property revaluation was HK$2,017 million *(2007: HK$3,675 million)*. Amounts of HK$1,543 million *(2007: HK$2,432 million)* and HK$71 million *(2007: HK$384 million)* were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$1,543 million *(2007: HK$2,432 million)* is stated after deduction of minority interests of HK$65 million *(2007: HK$201 million)* and deferred tax of HK$338 million *(2007: HK$658 million)*. The amount credited to the income statement comprises the surplus of HK$11 million on revaluation of investment properties and HK$60 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 94% by value of the group's properties subject to valuation, were valued by DTZ Debenham Tie Leung Limited who have recent experience in the location and type of properties. The valuations were carried out by qualified valuers who are members of the Hong Kong Institute of Surveyors. Properties in twelve countries, which represent 6% 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$153 million *(2007: HK$151 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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**128**	104	**6**	5
After one but within five years	**85**	61	**10**	–
	213	165	**16**	5

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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Leases over fifty years	**2,860**	2,884	**2,454**	2,470
Leases of between ten to fifty years	**1,037**	1,072	**119**	122
	3,897	3,956	**2,573**	2,592

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

27 Other assets

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Current taxation recoverable	**1,371**	1,104	**1,210**	1,060
Assets held for sale	**338**	473	**123**	219
Prepayments and accrued income	**6,557**	6,737	**5,091**	4,618
Accrued interest receivable	**12,493**	16,031	**7,262**	9,238
Acceptances and endorsements	**31,453**	31,918	**26,006**	25,801
Other accounts	**23,719**	13,831	**10,320**	8,681
	75,931	70,094	**50,012**	49,617

In both 2008 and 2007, assets held for sale mainly comprised assets acquired by repossession of collateral for realisation.

28 Customer accounts

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Current accounts	**408,891**	417,786	**290,299**	280,498
Savings accounts	**1,172,406**	983,874	**824,854**	699,643
Other deposit accounts	**994,787**	1,084,446	**651,848**	741,859
	2,576,084	2,486,106	**1,767,001**	1,722,000

29 Trading liabilities

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit in issue	**8,593**	25,234	**6,040**	23,902
Other debt securities in issue	**36,505**	55,945	**25,619**	38,627
Short positions in securities	**32,511**	59,200	**23,745**	33,789
Deposits by banks	**8,611**	28,799	**8,611**	12,344
Customer accounts	**124,367**	96,497	**87,074**	59,637
	210,587	265,675	**151,089**	168,299

30 Financial liabilities designated at fair value

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Deposits by banks	**258**	728	**258**	728
Customer accounts	**1,782**	2,638	**1,782**	2,638
Subordinated liabilities (note 36)	**994**	989	**–**	–
Debt securities in issue	**6,102**	–	**5,046**	–
Liabilities to customers under investment contracts	**30,790**	33,792	**–**	–
	39,926	38,147	**7,086**	3,366

At 31 December 2008 the carrying amount of financial liabilities designated at fair value was HK$140 million lower than the contractual amount at maturity (*2007: HK$6 million*). At 31 December 2008, the accumulated gain in fair value attributable to changes in credit risk was HK$78 million (*2007: HK$12 million*).

Notes on the Financial Statements (continued)

31 Debt securities in issue

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit	**33,051**	64,340	**25,942**	39,269
Other debt securities	**15,749**	20,183	**8,913**	8,914
	48,800	84,523	**34,855**	48,183

32 Other liabilities and provisions

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**19,717**	23,910	**13,588**	17,139
Provisions for liabilities and charges (note 35)	**1,093**	817	**714**	454
Dividend payable	**–**	–	**–**	–
Acceptances and endorsements	**31,479**	31,918	**26,032**	25,801
Other liabilities	**11,030**	13,558	**7,563**	9,454
	63,319	70,203	**47,897**	52,848

33 Liabilities under insurance contracts issued

	2008		
	Gross	**Reinsurance**	**Net**
	HK$m	**HK$m**	**HK$m**
Non-life insurance			
Unearned premiums	**1,117**	**(78)**	**1,039**
Outstanding claims	**1,024**	**(233)**	**791**
Claims incurred but not reported	**389**	**(49)**	**340**
Provision for unexpired risk	**8**	**–**	**8**
Other	**206**	**(1)**	**205**
	2,744	**(361)**	**2,383**
Policyholders' liabilities			
Life (non-linked)	**90,383**	**(144)**	**90,239**
Investment contracts with discretionary participation features	**260**	**–**	**260**
Life (linked)	**20,044**	**(7,334)**	**12,710**
	110,687	**(7,478)**	**103,209**
Total liabilities under insurance contracts	**113,431**	**(7,839)**	**105,592**

33 Liabilities under insurance contracts issued *(continued)*

	2007		
	Gross HK$m	Reinsurance HK$m	Net 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
	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

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

a *Movement of liabilities under insurance contracts*

(i) Non-life insurance

	2008		
	Gross HK$m	**Reinsurance HK$m**	**Net HK$m**
Unearned premiums			
At 1 January	**962**	**(76)**	**886**
Gross written premiums	**2,581**	**(351)**	**2,230**
Gross earned premiums	**(2,442)**	**347**	**(2,095)**
Foreign exchange and other movements	**16**	**2**	**18**
At 31 December	**1,117**	**(78)**	**1,039**
Notified and incurred but not reported claims			
At 1 January			
– Notified claims	**1,203**	**(294)**	**909**
– Claims incurred but not reported	**299**	**(59)**	**240**
	1,502	**(353)**	**1,149**
Claims paid in current year	**(1,184)**	**121**	**(1,063)**
Claims incurred	**1,102**	**(46)**	**1,056**
Foreign exchange and other movements	**(7)**	**(4)**	**(11)**
At 31 December			
– Notified claims	**1,024**	**(233)**	**791**
– Claims incurred but not reported	**389**	**(49)**	**340**
Total at 31 December	**1,413**	**(282)**	**1,131**

Notes on the Financial Statements (continued)

33 Liabilities under insurance contracts issued *(continued)*

	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

(ii) Policyholders' liabilities

	2008		
	Gross HK$m	**Reinsurance HK$m**	**Net HK$m**
Life (non-linked)			
At 1 January	**69,461**	**(51)**	**69,410**
Benefits paid	**(2,644)**	**58**	**(2,586)**
Claims incurred	**22,598**	**(133)**	**22,465**
Foreign exchange and other movements	**968**	**(18)**	**950**
At 31 December	**90,383**	**(144)**	**90,239**
Investment contracts with discretionary participation features			
At 1 January	**226**	**–**	**226**
Benefits paid	**(3)**	**–**	**(3)**
Claims incurred	**(9)**	**–**	**(9)**
Foreign exchange and other movements	**46**	**–**	**46**
At 31 December	**260**	**–**	**260**
Life (linked)			
At 1 January	**19,380**	**(9)**	**19,371**
Benefits paid	**(1,796)**	**234**	**(1,562)**
Claims incurred	**2,680**	**(11,425)**	**(8,745)**
Foreign exchange and other movements	**(220)**	**3,866**	**3,646**
At 31 December	**20,044**	**(7,334)**	**12,710**
Total policyholders' liabilities	**110,687**	**(7,478)**	**103,209**

33 Liabilities under insurance contracts issued *(continued)*

	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

Notes on the Financial Statements (continued)

34 Deferred tax

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

(i) Deferred tax assets

Group

	Accelerated capital allowances and short term timing differences	*Leasing transactions*	*Impairment losses on financial assets*	*Revaluation of properties*	*Others*	*Total*
2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January	**467**	**–**	**972**	**(395)**	**522**	**1,566**
Exchange and other adjustments	**(72)**	**–**	**(22)**	**(831)**	**(43)**	**(968)**
(Charge)/credit to income statement (note 6)	**(40)**	**–**	**247**	**57**	**117**	**381**
Credit to reserves	**–**	**–**	**–**	**22**	**698**	**720**
At 31 December	**355**	**–**	**1,197**	**(1,147)**	**1,294**	**1,699**
2007						
At 1 January	352	–	697	(238)	434	1,245
Exchange and other adjustments	30	–	(19)	(35)	20	(4)
(Charge)/credit to income statement (note 6)	85	–	294	(6)	(32)	341
(Charge)/credit to reserves	–	–	–	(116)	100	(16)
At 31 December	467	–	972	(395)	522	1,566

34 Deferred tax *(continued)*

Bank

2008	*Accelerated capital allowances and short term timing differences* HK$m	*Leasing transactions* HK$m	*Impairment losses on financial assets* HK$m	*Revaluation of properties* HK$m	*Others* HK$m	*Total* HK$m
At 1 January	**214**	**–**	**812**	**(408)**	**359**	**977**
Exchange and other adjustments	**36**	**–**	**(105)**	**(11)**	**(145)**	**(225)**
Credit to income statement (note 6)	**29**	**–**	**147**	**30**	**5**	**211**
(Charge) to reserves	**–**	**–**	**–**	**–**	**(144)**	**(144)**
At 31 December	**279**	**–**	**854**	**(389)**	**75**	**819**
2007						
At 1 January	28	–	630	(238)	333	753
Exchange and other adjustments	63	–	(65)	(48)	(61)	(111)
(Charge)/credit to income statement (note 6)	123	–	247	(6)	15	379
(Charge)/credit to reserves	–	–	–	(116)	72	(44)
At 31 December	214	–	812	(408)	359	977

(ii) Deferred tax liabilities

Group

2008	*Accelerated capital allowances and short term timing differences* HK$m	*Leasing transactions* HK$m	*Impairment losses on financial assets* HK$m	*Revaluation of properties* HK$m	*Others* HK$m	*Total* HK$m
At 1 January	**2,093**	**96**	**(292)**	**2,813**	**438**	**5,148**
Exchange and other adjustments	**(953)**	**(113)**	**100**	**(855)**	**849**	**(972)**
Charge/(credit) to income statement (note 6)	**1,166**	**(14)**	**(73)**	**(38)**	**(388)**	**653**
Charge/(credit) to reserves	**–**	**–**	**–**	**248**	**(644)**	**(396)**
At 31 December	**2,306**	**(31)**	**(265)**	**2,168**	**255**	**4,433**
2007						
At 1 January	313	229	(294)	2,311	1,725	4,284
Exchange and other adjustments	203	(125)	17	13	(50)	58
Charge/(credit) to income statement (note 6)	1,577	(8)	(15)	(32)	(655)	867
Charge/(credit) to reserves	–	–	–	521	(582)	(61)
At 31 December	2,093	96	(292)	2,813	438	5,148

Notes on the Financial Statements (continued)

34 Deferred tax *(continued)*

Bank

2008	*Accelerated capital allowances and short term timing differences* HK$m	*Leasing transactions* HK$m	*Impairment losses on financial assets* HK$m	*Revaluation of properties* HK$m	*Others* HK$m	*Total* HK$m
At 1 January	**1,945**	**90**	**(193)**	**1,219**	**(659)**	**2,402**
Exchange and other adjustments	**(860)**	**(133)**	**2**	**(38)**	**538**	**(491)**
Charge/(credit) to income statement (note 6)	**1,087**	**5**	**(76)**	**(28)**	**(511)**	**477**
Charge/(credit) to reserves	**–**	**–**	**–**	**278**	**(559)**	**(281)**
At 31 December	**2,172**	**(38)**	**(267)**	**1,431**	**(1,191)**	**2,107**
2007						
At 1 January	183	184	(210)	873	649	1,679
Exchange and other adjustments	197	(86)	19	6	(96)	40
Charge/(credit) to income statement (note 6)	1,565	(8)	(2)	(23)	(835)	697
Charge/(credit) to reserves	–	–	–	363	(377)	(14)
At 31 December	1,945	90	(193)	1,219	(659)	2,402

(iii) Net deferred tax liabilities

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Deferred tax liabilities recognised on the balance sheet	**4,433**	5,148	**2,107**	2,402
Deferred tax assets recognised on the balance sheet	**(1,699)**	(1,566)	**(819)**	(977)
	2,734	3,582	**1,288**	1,425

There is no significant deferred taxation liability not provided for.

At 31 December 2008, the group has not recognised potential future tax benefits of approximately HK$508 million *(2007 : HK$604 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.

35 Provisions for liabilities and charges

Group

	Provisions for commitments, guarantees and similar obligations	*Other provisions*	*Total*
	HK$m	**HK$m**	**HK$m**
2008			
At 1 January	**659**	**158**	**817**
Net charge to income statement	**293**	**129**	**422**
Provisions utilised	**(11)**	**(44)**	**(55)**
Exchange and other movements	**(46)**	**(45)**	**(91)**
At 31 December	**895**	**198**	**1,093**
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

Bank

	Provisions for contingent liabilities and commitments	*Other provisions*	*Total*
	HK$m	**HK$m**	**HK$m**
2008			
At 1 January	**312**	**142**	**454**
Net charge to income statement	**284**	**89**	**373**
Provisions utilised	**(11)**	**(22)**	**(33)**
Exchange and other movements	**(22)**	**(58)**	**(80)**
At 31 December	**563**	**151**	**714**
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

Notes on the Financial Statements (continued)

36 Subordinated liabilities

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

		2008 HK$m	2007 HK$m
US$1,200m	Primary capital subordinated undated floating rate notes*	**9,411**	9,415
Rs 2,000m	Fixed rate (13.05%) subordinated loans 2009	**319**	396
TW$1,499m**	Non-callable floating rate subordinated notes due 2009	**354**	–
TW$330m**	Non-callable floating rate subordinated notes due 2010	**78**	–
TW$1,865m**	Non-callable floating rate subordinated notes due 2010	**440**	–
Bank		**10,602**	9,811
A$42m	Subordinated floating rate notes callable quarterly from 2013 to 2018	**224**	–
A$200m	Subordinated floating rate notes callable quarterly from 2011 to 2016	**1,064**	1,364
HK$1,500m	Callable floating rate subordinated notes due 2015	**1,498**	1,497
US$450m	Callable floating rate subordinated notes due 2016	**3,478**	3,496
US$300m	Callable floating rate subordinated notes due 2017	**2,318**	2,332
Group		**19,184**	18,500

* *US$800 million of this subordinated capital is subject to an interest rate floor of 5%.*
** *These subordinated notes were acquired with the acquisition of the assets and liabilities of The Chinese Bank in Taiwan.*

The following subordinated note was classified as 'Financial liabilities designated at fair value' (note 30):

		Group	
		2008 HK$m	2007 HK$m
HK$1,000m	Callable fixed rate (4.125%) subordinated notes due 2015	**994**	989

37 Fair value of financial instruments

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial instruments measured at fair value on an ongoing basis include trading assets and liabilities, instruments designated at fair value through profit or loss, derivatives, and financial instruments classified as available-for-sale (including treasury and other eligible bills, debt securities and equity securities).

Control framework

Fair values are subject to a control framework that aims to ensure that they are either determined, or validated, by a function independent of the risk taker. To this end, ultimate responsibility for the determination of fair values lies with Finance, which reports functionally to the Group Finance Director. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

37 Fair value of financial instruments *(continued)*

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of valuation models, independent determination or validation of valuation model inputs, independent determination or validation of any adjustments required outside of the valuation model, and, where possible, independent validation of model outputs. For fair values determined without a valuation model, there is independent price determination or validation. The results of independent validation processes are reported to senior management, and adjustments to the fair values made as appropriate.

Determination of fair value of financial instruments carried at fair value

Fair values are determined according to the following hierarchy:

(a) Quoted market price

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.

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 price as appropriate. Long positions are marked at bid price; short positions are marked at offer price.

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

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

37 Fair value of financial instruments *(continued)*

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

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

– Loans

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

– Debt securities, Treasury and eligible bills, and Equities

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

– Derivatives

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

– Private equity

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.

Analysis of fair value determination

The following table provides an analysis of the basis for the valuation of financial assets and financial liabilities measured at fair value in the consolidated financial statements:

37 Fair value of financial instruments *(continued)*

Group

	Quoted market price	*Valuation techniques: using observable inputs*	*Valuation techniques: with significant non-observable inputs*	*Third Party Total*	*Amounts with HSBC entities*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2008						
Assets						
Trading assets	**202,855**	**284,515**	**6,300**	**493,670**	**–**	**493,670**
Financial assets designated at fair value	**16,894**	**21,688**	**1,971**	**40,553**	**–**	**40,553**
Derivatives	**1,498**	**359,348**	**4,642**	**365,488**	**88,435**	**453,923**
Available-for-sale investments[1]	**192,955**	**485,500**	**14,461**	**692,916**	**–**	**692,916**
Liabilities						
Trading liabilities	**37,163**	**161,272**	**12,152**	**210,587**	**–**	**210,587**
Financial liabilities designated at fair value	**–**	**39,926**	**–**	**39,926**	**–**	**39,926**
Derivatives	**976**	**356,433**	**5,410**	**362,819**	**103,385**	**466,204**
At 31 December 2007						
Assets						
Trading assets	218,306	142,044	354	360,704	–	360,704
Financial assets designated at fair value	36,305	26,041	806	63,152	–	63,152
Derivatives	2,279	142,255	5,110	149,644	30,796	180,440
Available-for-sale investments[1]	229,870	511,871	3,610	745,351	–	745,351
Liabilities						
Trading liabilities	71,785	181,685	12,205	265,675	–	265,675
Financial liabilities designated at fair value	–	38,147	–	38,147	–	38,147
Derivatives	5,456	130,082	5,730	141,268	32,054	173,322

Notes on the Financial Statements (continued)

37 Fair value of financial instruments *(continued)*

Bank

		Valuation techniques:				
	Quoted market price HK$m	*using observable inputs* HK$m	*with significant non-observable inputs* HK$m	*Third Party Total* HK$m	*Amounts with HSBC entities* HK$m	*Total* HK$m
At 31 December 2008						
Assets						
Trading assets	**187,534**	**136,984**	**4,605**	**329,123**	**–**	**329,123**
Financial assets designated at fair value	**–**	**1,503**	**225**	**1,728**	**–**	**1,728**
Derivatives	**1,031**	**347,798**	**4,372**	**353,201**	**99,008**	**452,209**
Available-for-sale investments[1]	**178,458**	**305,835**	**11,485**	**495,778**	**–**	**495,778**
Liabilities						
Trading liabilities	**33,589**	**112,094**	**5,406**	**151,089**	**–**	**151,089**
Financial liabilities designated at fair value	**–**	**7,086**	**–**	**7,086**	**–**	**7,086**
Derivatives	**933**	**345,022**	**5,410**	**351,365**	**106,367**	**457,732**
At 31 December 2007						
Assets						
Trading assets	166,955	93,152	–	260,107	–	260,107
Financial assets designated at fair value	–	2,861	–	2,861	–	2,861
Derivatives	2,265	136,565	5,110	143,940	34,244	178,184
Available-for-sale investments[1]	196,679	265,322	1,751	463,752	–	463,752
Liabilities						
Trading liabilities	47,781	113,741	6,777	168,299	–	168,299
Financial liabilities designated at fair value	–	3,366	–	3,366	–	3,366
Derivatives	5,352	125,810	5,730	136,892	34,101	170,993

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 9.*

37 Fair value of financial instruments *(continued)*

Effects of changes in significant non-observable assumptions to reasonably possibly alternatives:

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions.

Group	*Reflected in income statement*		*Reflected in equity*	
	Favourable changes	*Unfavourable changes*	*Favourable changes*	*Unfavourable changes*
	HK$m	**HK$m**	**HK$m**	**HK$m**
At 31 December 2008				
Derivatives/ trading assets/ trading liabilities	**1,404**	**(1,393)**	**–**	**–**
Financial assets/ liabilities designated at fair value	**175**	**(175)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**927**	**(1,154)**
At 31 December 2007				
Derivatives/ trading assets/ trading liabilities	417	(417)	–	–
Financial assets/ liabilities designated at fair value	81	(81)	–	–
Financial investments: available-for-sale	–	–	361	(361)

Bank	*Reflected in income statement*		*Reflected in equity*	
	Favourable changes	*Unfavourable changes*	*Favourable changes*	*Unfavourable changes*
	HK$m	**HK$m**	**HK$m**	**HK$m**
At 31 December 2008				
Derivatives/ trading assets/ trading liabilities	**1,321**	**(1,330)**	**–**	**–**
Financial assets/ liabilities designated at fair value	**–**	**–**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**578**	**(577)**
At 31 December 2007				
Derivatives/ trading assets/ trading liabilities	417	(417)	–	–
Financial assets/ liabilities designated at fair value	–	–	–	–
Financial investments: available-for-sale	–	–	175	(175)

Changes in fair value recorded in the income statement

The following table details changes in fair values recognised in the income statement during the period, where the fair value is estimated using valuation techniques that incorporate significant assumptions that are not supported by prices from observable current market transactions in the same instrument, and are not based on observable market data.

- the table details the total change in fair value of these instruments; it does not isolate that component of the change that is attributable to the non-observable component;
- instruments valued with significant non-observable inputs are frequently dynamically hedged with instruments valued using observable inputs; the table does not include any changes in fair value of these hedges; and
- there were significant assets and liabilities valued using observable inputs at 31 December 2007 that became valued with significant unobservable inputs during 2008; the table reflects the full change in fair value of those instruments during 2008, not just that element arising following the category change.

Notes on the Financial Statements (continued)

37 Fair value of financial instruments *(continued)*

Group	*Recorded in the income statement*	
	2008	2007
	HK$m	HK$m
At 31 December		
Derivatives/ trading assets/ trading liabilities	**(15)**	2,053
Financial assets/ liabilities designated at fair value	**633**	–

Bank	*Recorded in the income statement*	
	2008	2007
	HK$m	HK$m
At 31 December		
Derivatives/ trading assets/ trading liabilities	**479**	2,053
Financial assets/ liabilities designated at fair value	**16**	–

Fair value of financial instruments not carried at fair value

The fair values of financial instruments that are not recognised at fair value on the balance sheet are calculated as described below.

The calculation of fair value incorporates the group's estimate of the amount at which financial assets could be exchanged, or financial liabilities settled, between knowledgeable, willing parties in an arm's length transaction. It does not reflect the economic benefits and costs that the group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available, so comparisons of fair values between entities may not be meaningful and users are advised to exercise caution when using this data.

The following types of financial instruments are measured at amortised cost unless they are held for trading or designated at fair value through profit or loss. Where assets or liabilities are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the assets or liabilities so hedged includes a fair value adjustment for the hedged risk only. Fair values at the balance sheet date of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

– Advances to customers

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

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

– Financial investments

  The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration either the prices of, or future earning streams of, equivalent quoted securities.

– Deposits and customer accounts

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

– Debt securities in issue and subordinated liabilities

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

37 Fair value of financial instruments *(continued)*

The fair values in this note are stated at a specific date and may be significantly different from the amounts that will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realize immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the group as a going concern.

For all classes of financial instruments, fair value represents the product of the value of a single instrument, multiplied by the number of instruments held. No block discount or premium adjustments are made.

The fair values of intangible assets, such as values placed on portfolios of core deposits, credit card and customer relationships, are not included above because they are not financial instruments.

The following table lists those financial instruments for which their carrying amounts are a reasonable approximation of fair values because, for example, they are short term in nature or reprice to current market rates frequently:

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission to other banks
Items in the course of collection from other banks	Endorsements and acceptances
Endorsements and acceptances	Short-term payables within 'Other liabilities'
Short-term receivables within 'Other assets'	Accruals
Accrued income	

The following table provides an analysis of the fair value of financial instruments not measured at fair value in the balance sheet. For all other instruments the fair value is equal to the carrying value:

Group	**31 December 2008**		31 December 2007	
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
	HK$m	**HK$m**	HK$m	HK$m
Assets				
Loans and advances to banks	**392,300**	**392,612**	678,542	678,598
Loans and advances to customers	**1,286,145**	**1,263,077**	1,212,086	1,214,117
Financial instruments: debt securities	**81,974**	**88,807**	48,130	49,392
Liabilities				
Deposits by banks	**196,674**	**196,756**	169,177	169,180
Customer accounts	**2,576,084**	**2,577,936**	2,486,106	2,486,486
Debt securities in issue	**48,800**	**48,947**	84,523	84,446
Preference shares	**92,870**	**72,553**	90,328	89,069
Subordinated liabilities	**19,184**	**15,134**	18,500	16,672

Notes on the Financial Statements (continued)

37 Fair value of financial instruments *(continued)*

Bank	**31 December 2008**		31 December 2007	
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
	HK$m	**HK$m**	HK$m	HK$m
Assets				
Loans and advances to banks	**272,294**	**272,394**	507,894	507,950
Loans and advances to customers	**817,996**	**802,529**	743,530	743,443
Liabilities				
Deposits by banks	**174,532**	**174,606**	126,604	126,604
Customer accounts	**1,767,001**	**1,767,554**	1,722,000	1,722,268
Debt securities in issue	**34,855**	**34,906**	48,183	48,204
Preference shares	**92,870**	**72,553**	90,328	89,069
Subordinated liabilities	**10,602**	**8,027**	9,811	8,336

38 Preference shares

Authorised

At 31 December 2008, the authorised preference share capital of the Bank was US$12,400,500,000 *(2007: US$ 12,000,500,000)* comprising 2,700,500,000 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 *(2007: 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)*.

Issued and fully paid	*Bank and Group*	
	2008	2007
	HK$m	HK$m
Redeemable preference shares	**20,930**	17,940
Irredeemable preference shares	**68,069**	68,493
Share premium	**3,871**	3,895
	92,870	90,328

500,000 cumulative redeemable preference shares were issued in 1997, which have a mandatory redemption date of 2 January 2019 but may be redeemed at the Bank's option on or after 2 January 2003, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1,000 per share, comprising nominal value of US$1 per share and premium on issue of US$999 per share. 550,000,000 cumulative redeemable preference shares were issued in 2006, which have a mandatory redemption date of 21 December 2016 but may be redeemed at the Bank's option on or after 21 December 2011, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 1,750,000,000 cumulative redeemable preference shares were issued in 2007, which have mandatory redemption dates between 29 March and 24 November 2017 but may be redeemed at the Bank's option on or after dates starting between 29 March and 24 November 2012, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 400,000,000 cumulative redeemable preferences shares were issued during the year, which have a mandatory redemption date of 29 March 2023 but may be redeemed at the Bank's option on or after 29 March 2018, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. The total number of issued cumulative redeemable preference shares at 31 December 2008 was 2,700,500,000 *(2007: 2,300,500,000)*.

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 2008 was 6,653 million *(2007: 6,653 million)*. No shares were issued during the year *(2007: nil)*.

38 Preference shares *(continued)*

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 2008 was 2,130 million *(2007: 2,130 million)*. No shares were issued during the year *(2007: 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 2008 and 2007 was HK$30,000 million divided into 12,000 million ordinary shares of HK$2.50 each. No new shares were issued during 2008.

Issued and fully paid	*Bank and Group*	
	2008	2007
	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

	2008								
		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 2008	107,908	6,995	58,757	677	8,887	8,636	191,860	25,080	216,940
Unrealised surplus on revaluation	–	1,881	–	–	–	–	1,881	65	1,946
Transfer of depreciation	332	(332)	–	–	–	–	–	–	–
Realisation on disposal of properties	74	(74)	–	–	–	–	–	–	–
Profit for the year attributable to shareholders	50,306	–	–	–	–	–	50,306	–	50,306
Profit for the year attributable to minority interests	–	–	–	–	–	–	–	4,674	4,674
Dividends	(31,170)	–	–	–	–	–	(31,170)	(4,664)	(35,834)
Movement in respect of share-based payment arrangements	–	–	–	–	–	629	629	40	669
Actuarial losses on defined benefit plans	(5,051)	–	–	–	–	–	(5,051)	(1,143)	(6,194)
Fair value (losses)/gains taken to equity	–	–	(43,182)	3,853	–	–	(39,329)	(2,995)	(42,324)
Amounts transferred to the income statement	–	–	853	(2,510)	–	–	(1,657)	(22)	(1,679)
Transfer to income statement on change in fair value of hedged items	–	–	(1,785)	–	–	–	(1,785)	(188)	(1,973)
Share of changes recognised directly in equity of associates	8	276	(11)	–	–	(176)	97	–	97
Exchange differences	653	24	172	5	(8,500)	422	(7,224)	228	(6,996)
Deferred tax	716	(168)	428	(182)	–	–	794	322	1,116
Transfers	(708)	(24)	(158)	(10)	1,279	(379)	–	–	–
Other movements	17	–	29	–	–	551	597	–	597
Other increase in minority interest stake	–	–	–	–	–	–	–	1,477	1,477
At 31 December 2008	123,085	8,578	15,103	1,833	1,666	9,683	159,948	22,874	182,822

40 Reserves *(continued)*

Bank

	2008						
		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 2008	**58,096**	**2,154**	**53,309**	**535**	**4,245**	**1,017**	**119,356**
Unrealised surplus on revaluation	–	**1,791**	–	–	–	–	**1,791**
Transfer of depreciation	**198**	**(198)**	–	–	–	–	–
Realisation on disposal of properties	–	–	–	–	–	–	–
Profit for the year attributable to shareholders	**44,734**	–	–	–	–	–	**44,734**
Dividends	**(31,170)**	–	–	–	–	–	**(31,170)**
Movement in respect of share-based payment arrangements	–	–	–	–	–	**474**	**474**
Actuarial losses on defined benefit plans	**(2,850)**	–	–	–	–	–	**(2,850)**
Fair value losses taken to equity	–	–	**(35,383)**	**3,428**	–	–	**(31,955)**
Amounts transferred to the income statement	–	–	**(91)**	**(2,271)**	–	–	**(2,362)**
Transfer to income statement on change in fair value of hedged items	–	–	**(1,424)**	–	–	–	**(1,424)**
Exchange differences	**38**	–	**104**	**6**	**(8,508)**	**(39)**	**(8,399)**
Deferred tax	**421**	**(235)**	**122**	**(171)**	–	–	**137**
Transfers	**(46)**	–	**(60)**	**(11)**	**89**	**28**	–
Other movements	**3**	–	**7**	–	–	**715**	**725**
At 31 December 2008	**69,424**	**3,512**	**16,584**	**1,516**	**(4,174)**	**2,195**	**89,057**

Notes on the Financial Statements (continued)

40 Reserves *(continued)*

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)
Movement in respect of share-based payment arrangements	–	–	–	–	–	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)
Movement in respect of share-based payment arrangements	–	–	–	–	–	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

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 2008, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$4,395 million (*2007: HK$3,803 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

2008	*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	**259,394**	**232,320**	**34,508**	**58,793**	**12,557**	**–**	**–**	**–**	**–**	**597,572**
Items in the course of collection from other banks	**–**	**13,949**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**13,949**
Placings with banks maturing after one month	**–**	**–**	**45,022**	**6,741**	**3,793**	**13**	**–**	**–**	**–**	**55,569**
Certificates of deposit	**–**	**400**	**23,110**	**20,030**	**11,136**	**2,367**	**35**	**–**	**–**	**57,078**
Hong Kong SAR Government certificates of indebtedness	**119,024**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**119,024**
Trading assets	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**493,670**	**–**	**493,670**
Financial assets designated at fair value	**–**	**173**	**1,627**	**4,924**	**9,535**	**3,453**	**20,841**	**–**	**–**	**40,553**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**447,645**	**6,278**	**453,923**
Advances to customers	**127,110**	**128,385**	**132,790**	**173,891**	**409,325**	**325,602**	**(10,958)**	**–**	**–**	**1,286,145**
Financial investments	**5**	**26,337**	**34,842**	**89,405**	**338,253**	**59,173**	**38,146**	**–**	**–**	**586,161**
Amounts due from group companies	**49,803**	**236,092**	**1,971**	**12,449**	**9,532**	**15,440**	**–**	**53,375**	**–**	**378,662**
Investments in associates and joint ventures	**–**	**–**	**–**	**–**	**–**	**–**	**48,270**	**–**	**–**	**48,270**
Goodwill and intangible assets	**–**	**–**	**–**	**–**	**–**	**–**	**16,181**	**–**	**–**	**16,181**
Property, plant and equipment	**–**	**–**	**–**	**–**	**–**	**–**	**35,885**	**–**	**–**	**35,885**
Deferred tax assets	**–**	**–**	**–**	**–**	**–**	**–**	**1,699**	**–**	**–**	**1,699**
Retirement benefits	**–**	**–**	**–**	**–**	**–**	**–**	**84**	**–**	**–**	**84**
Other assets	**3,538**	**14,357**	**20,771**	**23,608**	**4,441**	**1,039**	**8,177**	**–**	**–**	**75,931**
Total assets at 31 December 2008	**558,874**	**652,013**	**294,641**	**389,841**	**798,572**	**407,087**	**158,360**	**994,690**	**6,278**	**4,260,356**

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	**119,024**	–	–	–	–	–	–	–	–	**119,024**
Items in the course of transmission to other banks	–	**31,334**	–	–	–	–	–	–	–	**31,334**
Deposits by banks	**123,384**	**37,491**	**24,814**	**10,321**	**450**	**214**	–	–	–	**196,674**
Customer accounts	**1,756,629**	**466,144**	**232,545**	**108,646**	**11,355**	**765**	–	–	–	**2,576,084**
Trading liabilities	–	–	–	–	–	–	–	**210,587**	–	**210,587**
Financial liabilities designated at fair value	**93**	**88**	**335**	**5,983**	**2,737**	**982**	**29,708**	–	–	**39,926**
Derivatives	–	–	–	–	–	–	–	**463,488**	**2,716**	**466,204**
Debt securities in issue	**1,065**	**5,102**	**16,277**	**16,662**	**6,352**	**3,342**	–	–	–	**48,800**
Retirement benefit liabilities	–	–	–	–	–	–	**7,486**	–	–	**7,486**
Amounts due to group companies	**14,471**	**11,421**	**1,582**	**2,185**	**14**	**2,092**	–	**19,479**	–	**51,244**
Other liabilities	**6,030**	**12,381**	**27,656**	**11,742**	**1,545**	**187**	**3,778**	–	–	**63,319**
Liabilities under insurance contracts issued	**257**	–	–	–	–	–	**113,174**	–	–	**113,431**
Current tax liabilities	–	**262**	**248**	**2,760**	–	–	–	–	–	**3,270**
Deferred tax liabilities	–	–	–	–	–	–	**4,433**	–	–	**4,433**
Subordinated liabilities	–	–	–	**673**	**9,100**	–	**9,411**	–	–	**19,184**
Preference shares	–	–	–	–	–	**24,801**	**68,069**	–	–	**92,870**
Total liabilities at 31 December 2008	**2,020,953**	**564,223**	**303,457**	**158,972**	**31,553**	**32,383**	**236,059**	**693,554**	**2,716**	**4,043,870**

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

Bank

2008	*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	**210,658**	**170,532**	**29,610**	**58,345**	**12,557**	**–**	**–**	**–**	**–**	**481,702**
Items in the course of collection from other banks	**–**	**9,908**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**9,908**
Placings with banks maturing after one month	**–**	**–**	**26,413**	**4,095**	**3,234**	**12**	**–**	**–**	**–**	**33,754**
Certificates of deposit	**–**	**–**	**19,019**	**15,437**	**2,524**	**–**	**–**	**–**	**–**	**36,980**
Hong Kong SAR Government certificates of indebtedness	**119,024**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**119,024**
Trading assets	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**329,123**	**–**	**329,123**
Financial assets designated at fair value	**–**	**138**	**–**	**83**	**937**	**570**	**–**	**–**	**–**	**1,728**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**447,586**	**4,623**	**452,209**
Advances to customers	**88,089**	**89,567**	**89,856**	**108,532**	**249,343**	**200,901**	**(8,292)**	**–**	**–**	**817,996**
Financial investments	**–**	**21,425**	**14,198**	**52,847**	**212,291**	**9,281**	**30,758**	**–**	**–**	**340,800**
Amounts due from group companies	**54,138**	**234,155**	**3,069**	**15,583**	**3,711**	**30,326**	**–**	**56,979**	**–**	**397,961**
Investments in subsidiary companies	**–**	**–**	**–**	**–**	**–**	**–**	**16,956**	**–**	**–**	**16,956**
Investments in associates and joint ventures	**–**	**–**	**–**	**–**	**–**	**–**	**21,132**	**–**	**–**	**21,132**
Goodwill and intangible assets	**–**	**–**	**–**	**–**	**–**	**–**	**6,368**	**–**	**–**	**6,368**
Property, plant and equipment	**–**	**–**	**–**	**–**	**–**	**–**	**21,384**	**–**	**–**	**21,384**
Deferred tax assets	**–**	**–**	**–**	**–**	**–**	**–**	**819**	**–**	**–**	**819**
Retirement benefits	**–**	**–**	**–**	**–**	**–**	**–**	**52**	**–**	**–**	**52**
Other assets	**2,874**	**9,071**	**17,476**	**9,631**	**3,871**	**555**	**6,534**	**–**	**–**	**50,012**
Total assets at 31 December 2008	**474,783**	**534,796**	**199,641**	**264,553**	**488,468**	**241,645**	**95,711**	**833,688**	**4,623**	**3,137,908**

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	119,024	–	–	–	–	–	–	–	–	119,024
Items in the course of transmission to other banks	–	26,581	–	–	–	–	–	–	–	26,581
Deposits by banks	105,898	33,837	24,400	10,183	–	214	–	–	–	174,532
Customer accounts	1,235,470	305,735	142,498	74,924	7,916	458	–	–	–	1,767,001
Trading liabilities	–	–	–	–	–	–	–	151,089	–	151,089
Financial liabilities designated at fair value	–	88	335	4,748	1,573	336	6	–	–	7,086
Derivatives	–	–	–	–	–	–	–	455,932	1,800	457,732
Debt securities in issue	1,065	4,334	13,615	12,282	3,559	–	–	–	–	34,855
Retirement benefit liabilities	–	–	–	–	–	–	3,550	–	–	3,550
Amounts due to group companies	20,891	35,790	13,265	11,053	48	2,094	–	34,540	–	117,681
Other liabilities	4,596	8,949	22,618	8,073	1,284	71	2,306	–	–	47,897
Current tax liabilities	–	237	215	2,128	–	–	–	–	–	2,580
Deferred tax liabilities	–	–	–	–	–	–	2,107	–	–	2,107
Subordinated liabilities	–	–	–	673	518	–	9,411	–	–	10,602
Preference shares	–	–	–	–	–	24,801	68,069	–	–	92,870
Total liabilities at 31 December 2008	1,486,944	415,551	216,946	124,064	14,898	27,974	85,449	641,561	1,800	3,015,187

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

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 ventures	–	–	–	–	–	–	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 ventures	–	–	–	–	–	–	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

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 2008						
Hong Kong SAR currency notes in circulation	**119,024**	**–**	**–**	**–**	**–**	**119,024**
Items in the course of transmission to other banks	**–**	**31,334**	**–**	**–**	**–**	**31,334**
Deposits by banks	**123,398**	**62,782**	**10,570**	**500**	**218**	**197,468**
Customer accounts	**1,757,891**	**701,645**	**111,025**	**13,200**	**936**	**2,584,697**
Financial liabilities designated at fair value	**93**	**442**	**6,185**	**2,829**	**30,800**	**40,349**
Debt securities in issue	**1,065**	**21,668**	**17,523**	**7,276**	**5,055**	**52,587**
Amounts due to group companies	**14,471**	**13,015**	**2,225**	**215**	**2,235**	**32,161**
Other financial liabilities	**5,224**	**35,742**	**11,331**	**3,159**	**469**	**55,925**
Subordinated liabilities	**–**	**243**	**1,291**	**11,566**	**13,582**	**26,682**
Preference shares	**–**	**1,049**	**2,983**	**16,130**	**128,449**	**148,611**
	2,021,166	**867,920**	**163,133**	**54,875**	**181,744**	**3,288,838**

	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

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 2008						
Hong Kong SAR currency notes in circulation	**119,024**	**–**	**–**	**–**	**–**	**119,024**
Items in the course of transmission to other banks	**–**	**26,581**	**–**	**–**	**–**	**26,581**
Deposits by banks	**105,910**	**58,678**	**10,401**	**9**	**218**	**175,216**
Customer accounts	**1,236,360**	**450,336**	**76,123**	**9,336**	**557**	**1,772,712**
Financial liabilities designated at fair value	**–**	**429**	**4,873**	**1,648**	**469**	**7,419**
Debt securities in issue	**1,065**	**18,063**	**12,788**	**3,662**	**–**	**35,578**
Amounts due to group companies	**20,891**	**49,063**	**11,091**	**249**	**2,237**	**83,531**
Other financial liabilities	**4,225**	**28,427**	**7,968**	**2,498**	**68**	**43,186**
Subordinated liabilities	**–**	**146**	**1,000**	**2,247**	**13,582**	**16,975**
Preference shares	**–**	**1,049**	**2,983**	**16,130**	**128,449**	**148,611**
	1,487,475	**632,772**	**127,227**	**35,779**	**145,580**	**2,428,833**

	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

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$1,151 billion), include cash and short-term funds and items in the course of collection (HK$612 billion); placings with banks maturing after one month (HK$56 billion, including HK$52 billion repayable within one year); and advances to customers (HK$1,286 billion, including HK$562 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's approach to managing liquidity risk is set out in note 52b.

Notes on the Financial Statements (continued)

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

	2008 HK$m	2007 HK$m
Operating profit	**60,001**	74,026
Net interest income	**(69,045)**	(62,761)
Dividend income	**(852)**	(693)
Depreciation and amortisation	**3,441**	2,708
Amortisation of prepaid operating lease payments	**59**	59
Loan impairment charges and other credit risk provisions	**12,000**	5,805
Advances written off net of recoveries	**(5,556)**	(5,293)
Other provisions for liabilities and charges	**553**	(353)
Provisions utilised	**(55)**	(81)
Surplus arising on property revaluation	**(60)**	(122)
Gains on investment properties	**(11)**	(564)
Loss / (profit) on disposal of property, plant and equipment and assets held for sale	**63**	(64)
Loss / (profit) on disposal of subsidiaries, associates and business portfolios	**96**	(96)
Gains less losses from dilution of investments in associates	**–**	(4,735)
Gains less losses from financial investments	**2,976**	(892)
Share based payments granted cost free	**1,045**	311
Interest received	**108,097**	115,996
Interest paid	**(52,474)**	(73,519)
Operating profit before changes in working capital	**60,278**	49,732
Change in treasury bills with original term to maturity of more than three months	**11,395**	(16,293)
Change in placings with banks maturing after one month	**3,627**	46,371
Change in certificates of deposit with original term to maturity of more than three months	**30,921**	(8,165)
Change in trading assets	**(99,209)**	11,027
Change in trading liabilities	**(55,088)**	(6,870)
Change in financial assets designated as fair value	**22,599**	(12,654)
Change in financial liabilities designated as fair value	**1,779**	1,593
Change in derivatives assets	**(273,604)**	(81,112)
Change in derivatives liabilities	**293,001**	74,584
Change in financial investments held for backing liabilities to long-term policyholders	**(35,484)**	(4,332)
Change in advances to customers	**(68,824)**	(165,387)
Change in amounts due from group companies	**(13,931)**	(196,830)
Change in other assets	**(24,684)**	(22,816)
Change in deposits by banks	**19,931**	57,485
Change in customer accounts	**73,722**	492,164
Change in amounts due to group companies	**(12,983)**	27,386
Change in debt securities in issue	**(36,723)**	15,328
Change in liabilities under insurance contracts	**21,701**	30,380
Change in other liabilities	**16,002**	(3,628)
Exchange adjustments	**(9,915)**	4,368
Cash (used in)/ generated from operations	**(75,489)**	292,331

44 Analysis of cash and cash equivalents

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

	2008 **HK$m**	2007 HK$m
Balance at 1 January	**819,637**	510,609
Net cash (outflow) / inflow before the effect of foreign exchange movements	**(158,792)**	289,486
Effect of foreign exchange movements	**(9,960)**	19,542
Balance at 31 December	**650,885**	819,637

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

	2008 **HK$m**	2007 HK$m
Cash in hand and sight balances with central banks	**129,190**	12,829
Items in the course of collection from other banks	**13,949**	20,357
Placings with banks	**380,628**	652,545
Treasury bills	**136,356**	135,716
Certificates of deposit	**22,096**	29,519
Other eligible bills	**–**	257
Less: items in the course of transmission to other banks	**(31,334)**	(31,586)
	650,885	819,637

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

	2008 **HK$m**	2007 HK$m
Cash consideration	**(1,371)**	(149)
Cash and cash equivalents acquired	**131**	15
	(1,240)	(134)

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

	2008 **HK$m**	2007 HK$m
Sale proceeds	**–**	111
Cash and cash equivalents transferred	**–**	–
	–	111

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

	2008 **HK$m**	2007 HK$m
Sale proceeds	**1,876**	1,948
Cash and cash equivalents transferred	**(1,909)**	–
	(33)	1,948

Notes on the Financial Statements (continued)

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

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

	2008	2007
	HK$m	HK$m
Cash consideration received/ (paid)	**12,274**	(780)
Cash and cash equivalents acquired	**1,718**	2,779
	13,992	1,999

45 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	Group		Bank	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	**143,797**	161,493	**122,110**	140,882
Other contingent liabilities	**165**	122	**165**	122
	143,962	161,615	**122,275**	141,004
Commitments				
Documentary credits and short-term trade-related transactions	**30,874**	54,803	**25,394**	45,430
Forward asset purchases and forward forward deposits placed	**1,369**	461	**706**	–
Undrawn note issuing and revolving underwriting facilities	**–**	–	**–**	–
Undrawn formal standby facilities, credit lines and other commitments to lend				
– 1 year and under	**1,045,637**	1,037,691	**800,042**	783,607
– over 1 year	**72,723**	93,111	**56,976**	65,526
	1,150,603	1,186,066	**883,118**	894,563

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 2008, were as follows:

Group	**At 31 December 2008**		At 31 December 2007	
	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]	**21,093**	**1,952**	26,157	3,912
Standby letters of credit which are financial guarantee contracts[2]	**21,424**	**28**	25,366	28
Other direct credit substitutes[3]	**26,565**	**20**	30,384	21
Performance bonds[4]	**40,440**	**3,585**	35,666	3,628
Bid bonds[4]	**1,207**	**157**	2,223	147
Standby letters of credit related to particular transactions[4]	**2,481**	**37**	4,942	137
Other transaction-related guarantees[4]	**23,438**	**3,494**	27,559	4,509
	136,648	**9,273**	152,297	12,382

Bank	**At 31 December 2008**		At 31 December 2007	
	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]	**16,418**	**1,952**	23,555	3,912
Standby letters of credit which are financial guarantee contracts[2]	**17,665**	**28**	22,169	28
Other direct credit substitutes[3]	**23,709**	**20**	27,390	21
Performance bonds[4]	**33,071**	**3,351**	28,639	3,339
Bid bonds[4]	**1,042**	**156**	2,005	147
Standby letters of credit related to particular transactions[4]	**1,583**	**33**	3,925	137
Other transaction-related guarantees[4]	**19,987**	**3,096**	21,521	4,095
	113,475	**8,636**	129,204	11,679

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$68,570 million *(2007: HK$64,388 million)* and of the Bank amounting to HK$56,407 million *(2007: HK$28,430 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$72,543 million *(2007: HK$73,594 million)* and by the Bank is HK$60,337 million *(2007: HK$37,802 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 was permitted to be sold or repledged amounted to HK$287,398 million *(2007: HK$289,075 million[1])*, and by the Bank of HK$276,727 million *(2007: HK$266,632 million[1])*. The fair value of such collateral actually sold or repledged by the group amounted to HK$39,789 million *(2007: HK$58,300 million[1])* and by the Bank of HK$39,789 million *(2007: HK$44,839 million[1])*.

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

1 *The comparatives have been restated to be consistent with the current years presentation.*

47 Capital commitments

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**4,804**	3,053	**2,242**	2,267
Expenditure authorised by the Directors but not contracted for	**1,056**	258	**1,056**	256
	5,860	3,311	**3,298**	2,523

The capital commitments mainly relate to the commitment to purchase premises and equipment as well as to invest in the HSBC Private Equity Fund 6 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.

In addition, the following agreement has been entered into to acquire a business that is expected to be effected after the date of these financial statements are authorised for issue, subject to regulatory approval.

Agreement to acquire PT Bank Ekonomi Raharja Tbk

In October 2008, the group agreed to acquire 88.89 per cent of PT Bank Ekonomi Raharja Tbk ('Bank Ekonomi') from PT Lumbung Artakencana, PT Alas Pusaka and from individual shareholders. The consideration is US$607.5 million, payable in cash.

Under Indonesian law, the group will be required to make a Mandatory Tender Offer for the remaining 10.11 per cent of the shares.

47 Capital commitments *(continued)*

The acquisition is subject to obtaining the necessary regulatory approvals in Indonesia and elsewhere. Following completion, Bank Ekonomi will be accounted for as a subsidiary in the group's consolidated financial statements.

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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**2,212**	1,804	**1,310**	1,046
– five years or less but over one year	**3,039**	2,685	**2,018**	1,464
– over five years	**187**	391	**185**	334
	5,438	4,880	**3,513**	2,844
Equipment				
Amounts payable within				
– one year or less	**61**	75	**35**	32
– five years or less but over one year	**47**	89	**29**	50
– over five years	**–**	–	**–**	–
	108	164	**64**	82

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:

	2008		2007	
	HK$m	**%**	HK$m	%
Hong Kong	**2,801,867**	**65.7**	2,549,605	64.6
Rest of Asia-Pacific	**1,443,310**	**33.9**	1,388,786	35.1
Americas/Europe	**15,179**	**0.4**	13,548	0.3
Total assets	**4,260,356**	**100.0**	3,951,939	100.0

Notes on the Financial Statements (continued)

49 Segmental analysis *(continued)*

Total liabilities:

	2008		2007	
	HK$m	**%**	HK$m	%
Hong Kong	**2,682,459**	**66.3**	2,418,120	65.2
Rest of Asia-Pacific	**1,346,445**	**33.3**	1,274,563	34.4
Americas/Europe	**14,966**	**0.4**	13,322	0.4
Total liabilities	**4,043,870**	**100.0**	3,706,005	100.0

Net assets:

	2008		2007	
	HK$m	**%**	HK$m	%
Hong Kong	**119,408**	**55.2**	131,485	53.5
Rest of Asia-Pacific	**96,865**	**44.7**	114,223	46.4
Americas/Europe	**213**	**0.1**	226	0.1
	216,486	**100.0**	245,934	100.0

Minority interests are included in the above table.

Capital additions during the year:

	2008		2007	
	HK$m	**%**	HK$m	%
Hong Kong	**3,438**	**42.7**	3,403	75.3
Rest of Asia-Pacific	**4,622**	**57.3**	1,115	24.7
	8,060	**100.0**	4,518	100.0

Investment in associates and joint ventures:

	2008		2007	
	HK$m	**%**	HK$m	%
Hong Kong	**1,189**	**2.5**	1,211	3.0
Rest of Asia-Pacific	**47,081**	**97.5**	38,621	97.0
	48,270	**100.0**	39,832	100.0

Credit commitments (contract amounts):

	2008		2007	
	HK$m	**%**	HK$m	%
Hong Kong	**709,535**	**54.8**	715,730	53.1
Rest of Asia-Pacific	**585,030**	**45.2**	631,951	46.9
	1,294,565	**100.0**	1,347,681	100.0

Goodwill and intangible assets acquired in the year through business combinations:

	2008		2007	
	HK$m	**%**	HK$m	%
Hong Kong	–	–	4	7.5
Rest of Asia-Pacific	**2,716**	**100.0**	49	92.5
	2,716	**100.0**	53	100.0

49 Segmental analysis *(continued)*

Consolidated income statement:

2008	*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	**65,812**	**59,736**	**316**	**–**	**125,864**
Inter-segment interest income	**3,208**	**1,815**	**188**	**(5,211)**	**–**
Interest income	**69,020**	**61,551**	**504**	**(5,211)**	**125,864**
Interest expense to third parties and fellow subsidiaries	**(24,451)**	**(32,069)**	**(299)**	**–**	**(56,819)**
Inter-segment interest expense	**(1,890)**	**(3,154)**	**(159)**	**5,203**	**–**
Interest expense	**(26,341)**	**(35,223)**	**(458)**	**5,203**	**(56,819)**
Net interest income	**42,679**	**26,328**	**46**	**(8)**	**69,045**
Fee income	**22,338**	**16,406**	**–**	**(993)**	**37,751**
Fee expense	**(3,880)**	**(4,101)**	**4**	**993**	**(6,984)**
Net trading income	**7,201**	**14,150**	**4**	**8**	**21,363**
Net loss from financial instruments designated at fair value	**(9,607)**	**(1,375)**	**–**	**–**	**(10,982)**
Gains less losses from financial investments	**(2,848)**	**(128)**	**–**	**–**	**(2,976)**
Dividend income	**363**	**489**	**–**	**–**	**852**
Net earned insurance premiums	**25,351**	**1,535**	**–**	**–**	**26,886**
Other operating income	**6,525**	**1,200**	**22**	**(3,671)**	**4,076**
Total operating income	**88,122**	**54,504**	**76**	**(3,671)**	**139,031**
Net insurance claims incurred and movement in policyholders' liabilities	**(14,981)**	**214**	**–**	**–**	**(14,767)**
Net operating income before loan impairment charges and other credit risk provisions	**73,141**	**54,718**	**76**	**(3,671)**	**124,264**
Loan impairment charges and other credit risk provisions	**(5,837)**	**(6,171)**	**8**	**–**	**(12,000)**
Net operating income	**67,304**	**48,547**	**84**	**(3,671)**	**112,264**
Operating expenses	**(28,811)**	**(27,090)**	**(33)**	**3,671**	**(52,263)**
Operating profit	**38,493**	**21,457**	**51**	**–**	**60,001**
Share of profit in associates and joint ventures	**120**	**7,569**	**–**	**–**	**7,689**
Profit before tax	**38,613**	**29,026**	**51**	**–**	**67,690**
Tax expense	**(6,626)**	**(6,077)**	**(7)**	**–**	**(12,710)**
Profit for the year	**31,987**	**22,949**	**44**	**–**	**54,980**
Profit attributable to shareholders	**27,844**	**22,418**	**44**	**–**	**50,306**
Profit attributable to minority interests	**4,143**	**531**	**–**	**–**	**4,674**
Net operating income					
– external	**59,549**	**47,481**	**(123)**	**–**	**106,907**
– inter-company/inter-segment	**7,755**	**1,066**	**207**	**(3,671)**	**5,357**
Depreciation and amortisation included in operating expenses	**(2,518)**	**(923)**	**–**	**–**	**(3,441)**

Notes on the Financial Statements (continued)

49 Segmental analysis *(continued)*

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 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)

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)*

2008	*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)	37,702	17,958	23,075	43	(5,497)	(4,236)	69,045
Net fee income	15,317	6,790	8,319	83	258	–	30,767
Net trading income	1,570	1,403	14,367	165	(302)	4,160	21,363
Net (loss)/ income from financial instruments designated at fair value	(11,394)	(77)	266	–	147	76	(10,982)
Gains less losses from financial investments	1,228	250	(571)	–	(3,883)	–	(2,976)
Dividend income	27	17	173	–	635	–	852
Net earned insurance premiums	25,061	1,649	159	–	17	–	26,886
Other operating income	1,406	841	582	22	7,392	(6,167)	4,076
Total operating income	70,917	28,831	46,370	313	(1,233)	(6,167)	139,031
Net insurance claims incurred and movement in policyholders' liabilities	(13,470)	(1,178)	(107)	–	(12)	–	(14,767)
Net operating income before loan impairment charges and other credit risk provisions	57,447	27,653	46,263	313	(1,245)	(6,167)	124,264
Loan impairment charges and other credit risk provisions	(5,625)	(3,630)	(2,754)	–	9	–	(12,000)
Net operating income	51,822	24,023	43,509	313	(1,236)	(6,167)	112,264
Operating expenses	(27,242)	(9,231)	(14,237)	(326)	(7,394)	6,167	(52,263)
Operating profit/(loss)	24,580	14,792	29,272	(13)	(8,630)	–	60,001
Share of profit in associates and joint ventures	968	4,367	2,213	–	141	–	7,689
Profit/(loss) before tax	25,548	19,159	31,485	(13)	(8,489)	–	67,690
Net operating income							
– external	24,872	21,293	64,982	(46)	(4,193)	–	106,908
– inter-company/ inter-segment	26,950	2,730	(21,473)	359	2,957	(6,167)	5,356
Segment assets	797,888	457,526	2,871,309	6,163	506,120	(426,920)	4,212,086
Investments in associates and joint ventures	6,373	23,229	12,015	–	6,653	–	48,270
Total assets	804,261	480,755	2,883,324	6,163	512,773	(426,920)	4,260,356
Net assets	41,512	47,405	77,536	213	49,820	–	216,486
Capital additions during the year	3,637	1,085	484	13	2,841	–	8,060

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

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 2008, the Bank has issued HK$92,870 million of preference shares to its immediate holding company (*2007: HK$90,328 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 2008, the Bank has issued HK$2,091 million of subordinated liabilities to its ultimate holding company (*2007: HK$2,133million*). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		*Ultimate holding company*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**4,946**	5,346	**78**	124
Other operating income	**–**	–	**28**	19
Other operating expenses	**62**	71	**1,335**	1,193

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) and preference shares issued (note 38).

Interest expense on subordinated liabilities issued to the ultimate holding company amounted to HK$78 million for the year (*2007: HK$124 million*).

Balances at 31 December

Group

	Immediate holding company		*Ultimate holding company*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**–**	–	**–**	–
Amounts due to[1]	**94,786**	93,054	**2,317**	2,775

Bank

	Immediate holding company		*Ultimate holding company*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**–**	–	**–**	–
Amounts due to[1]	**94,786**	93,054	**2,265**	2,726

1 *Amounts due to the immediate holding company included preference shares of HK$92,870 million (2007: HK$90,328 million). As at 31 December 2008 and 31 December 2007, all preference shares were held by the immediate holding company. Amounts due to the ultimate holding company included subordinated liabilities of HK$2,091 million (2007: HK$2,133 million).*

Guarantees made by the ultimate holding company on behalf of the group amounted to HK$3,975 million *(2007: HK$7,029 million).*

50 Related-party transactions *(continued)*

Share option and share award schemes

The group participates in various share option and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the group. As disclosed in note 51, the group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under 'Other reserves'. The balance of this reserve as at 31 December 2008 amounted to HK$2,805 million comprising HK$1,656 million relating to share option schemes and HK$1,149 million relating to share award schemes *(2007: HK$1,364 million relating to share option schemes only)*.

b *Subsidiaries and fellow subsidiaries*

In 2008, 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 on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The group shared certain IT projects with its fellow subsidiaries and also used certain processing services of fellow subsidiaries on a cost recovery basis. The Bank also acted as agent for the distribution of retail investment funds for fellow 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	
	2008	2007
	HK$m	HK$m
Interest income	**8,063**	8,717
Interest expense	**730**	911
Fee income	**2,438**	2,276
Fee expense	**1,284**	1,143
Other operating income	**1,817**	1,396
Other operating expenses[1]	**4,459**	3,527

1 *2008 included payment of HK$928 million (2007: HK$739 million) of software costs which were capitalised as intangible assets in the balance sheet of the group.*

Balances at 31 December

Group

	Fellow subsidiaries	
	2008	2007
	HK$m	HK$m
Amounts due from	**378,662**	364,724
Amounts due to	**47,011**	60,345

Bank

	Subsidiaries		*Fellow subsidiaries*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**32,242**	43,495	**365,719**	337,741
Amounts due to	**70,427**	40,549	**43,073**	54,965

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; and

– principal associates.

The group has entered into Technical Support and Assistance Agreements with Bank of Communications ('BoCom'), Industrial Bank, Vietnam Technological and Commercial Joint Stock Bank, Hana HSBC Life Insurance and Canara HSBC Oriental Bank of Commerce Life Insurance to provide technical support and assistance in relation to their banking and insurance business. The Bank has continued to assist BoCom in growing its credit card division and has provided technical support in the issuing of co-branded credit cards with HSBC.

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

d *Key management personnel*[1]

Key management compensation

	2008	2007
	HK$m	HK$m
Salaries and other short-term benefits	**180**	214
Retirement benefits		
– Defined contribution plans	**9**	10
– Defined benefit plans	**3**	3
Share-based payments	**51**	18
	243	245

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:

	2008	2007
	HK$m	HK$m
Average assets	**25,159**	24,014
Average liabilities	**23,958**	18,872

The aggregate contribution to the group's profit before tax from such transactions in 2008 was HK$484 million (*2007: HK$524 million*). As at the balance sheet date, guarantees made on behalf of such companies were HK$6,957 million (*2007: HK$1,469 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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
By the Bank	**60**	172	**191**	195
By subsidiary companies	**–**	–	**1**	1
	60	172	**192**	196

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 2008, HK$10.8 billion *(2007: HK$10.7 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$39 million for the year (*2007: HK$43 million*).

51 Share-based payments

During 2008, HK$1,045 million was charged to the income statement in respect of share-based payment transactions settled in equity *(2007:HK$787 million comprising HK$311 million settled in equity and HK$476 million cash-settled transactions)*. This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the Group's reward structures.

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:

2008	*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] (%)	**4.5**	**4.5**	**4.5**
Expected life[2] (years)	**1**	**3**	**5**
Expected volatility[3] (%)	**25**	**25**	**25**

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

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 were awarded share options between 1993 and 2005. The aim of the plan was to align the interests of those employees assessed as higher-performing to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets which must normally be attained in order for the awards to vest.

The 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

	2008		2007	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**22,944**	**7.87**	24,421	7.84
Exercised in the year	**(1,262)**	**6.77**	(919)	7.44
Lapsed in the year	**(488)**	**8.41**	(558)	8.18
Outstanding at 31 December	**21,194**	**7.93**	22,944	7.87
Exercisable at 31 December	**21,194**	**7.93**	22,944	7.87

Bank

	2008		2007	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**17,861**	**7.87**	18,910	7.82
Exercised in the year	**(1,006)**	**6.75**	(663)	7.47
Lapsed in the year	**(363)**	**8.45**	(386)	8.16
Outstanding at 31 December	**16,492**	**7.92**	17,861	7.87
Exercisable at 31 December	**16,492**	**7.92**	17,861	7.87

The options outstanding at the year end had an exercise price in the range of £6.38 to £9.14 (*2007: £6.28 to £9.14*), and a weighted average remaining contractual life of 3.63 years (*2007: 4.54 years*).

The weighted average share price during the year was £7.99 (*2007: £9.03*).

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 (*2007: 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.

Notes on the Financial Statements (continued)

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

	2008		2007	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**14,934**	**6.55**	19,519	6.49
Granted in the year	**2,568**	**6.82**	2,289	7.09
Forfeited/expired in the year	**(1,046)**	**6.87**	(1,291)	6.73
Exercised in the year	**(8,263)**	**6.32**	(5,583)	6.51
Outstanding at 31 December	**8,193**	**6.82**	14,934	6.55
Exercisable at 31 December	**338**	**6.40**	104	6.56

Bank

	2008		2007	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**11,741**	**6.56**	14,506	6.49
Granted in the year	**2,171**	**6.82**	1,952	7.09
Forfeited/expired in the year	**(875)**	**6.89**	(897)	6.82
Exercised in the year	**(6,389)**	**6.31**	(3,820)	6.52
Outstanding at 31 December	**6,648**	**6.83**	11,741	6.56
Exercisable at 31 December	**276**	**6.38**	86	6.57

The options outstanding at the year end had an exercise price in the range of £5.35 to £7.67 (*2007: £5.35 to £7.67*), and a weighted average remaining contractual life of 1.98 years (*2007: 2.77 years*).

The weighted average share price at the date of exercise for share options exercised during the year was £8.44 (*2007: £8.96*).

The weighted average fair value of options granted during the year was £2.10 (*2007: £2.14*).

51 Share-based payments *(continued)*

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

Group

	2008		2007	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**HK$**	(000's)	HK$
Outstanding at 1 January	**12,186**	**106.51**	6,313	103.44
Granted in the year	**7,998**	**106.25**	7,702	108.45
Forfeited/expired in the year	**(4,120)**	**106.55**	(712)	105.10
Exercised in the year	**(1,660)**	**106.42**	(1,117)	103.44
Outstanding at 31 December	**14,404**	**106.14**	12,186	106.51
Exercisable at 31 December	**30**	**108.45**	2	103.44

Bank

	2008		2007	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**HK$**	(000's)	HK$
Outstanding at 1 January	**8,042**	**106.38**	4,322	103.44
Granted in the year	**5,425**	**106.25**	4,879	108.45
Forfeited/expired in the year	**(3,279)**	**106.41**	(481)	105.00
Exercised in the year	**(946)**	**108.41**	(678)	103.45
Outstanding at 31 December	**9,242**	**106.10**	8,042	106.38
Exercisable at 31 December	**22**	**108.45**	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 (*2007: HK$103.44 to HK$108.45*), and a weighted average remaining contractual life of 2.33 years (*2007: 3.69 years*).

The weighted average share price at the date of exercise for share options exercised during the year was HK$124.65 (*2007:HK$140.70*).

The weighted average fair value of options granted during the year was HK$29.64 (*2007: HK$33.48*).

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.

Notes on the Financial Statements (continued)

51 Share-based payments *(continued)*

c *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*	
	2008 *Number* **(000's)**	2007 *Number* (000's)	**2008** *Number* **(000's)**	2007 *Number* (000's)
Outstanding at 1 January	**2,430**	3,092	**2,003**	2,530
Additions during the year	**361**	542	**353**	517
Released in the year	**(674)**	(446)	**(478)**	(360)
Lapsed in the year	**(925)**	(758)	**(757)**	(684)
Outstanding at 31 December	**1,192**	2,430	**1,121**	2,003

The weighted average remaining vesting period was 0.94 years (*2007: 0.75 years*).

The weighted average fair value of shares granted during the year with TSR conditions as at the year end was £5.71 (*2007: £4.38*) while shares with EPS conditions had a fair value of £6.62 (*2007:* £8.42) as at year end.

d *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 the date of the award.

	Group		*Bank*	
	2008 *Number* **(000's)**	2007 *Number* (000's)	**2008** *Number* **(000's)**	2007 *Number* (000's)
Outstanding at 1 January	**6,517**	5,947	**6,527**	5,904
Additions during the year	**6,685**	3,827	**4,563**	3,824
Released in the year	**(2,623)**	(2,473)	**(2,244)**	(2,417)
Lapsed in the year	**(582)**	(784)	**(413)**	(784)
Outstanding at 31 December	**9,997**	6,517	**8,433**	6,527

The weighted average remaining vesting period as at year end was 1.78 years (*2007: 1.64 years*).

The closing price of HSBC Holdings shares on 31 December 2008 was £6.62 (*29 December 2007: £8.42*).

51 Share-based payments *(continued)*

e *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*	
	2008	2007	**2008**	2007
	Number	*Number*	*Number*	*Number*
	(000's)	(000's)	**(000's)**	(000's)
Outstanding at 1 January	**3,685**	1,549	**3,063**	1,259
Granted in the year	**3,069**	2,359	**2,417**	1,962
Released in the year	**(934)**	(36)	**(790)**	(22)
Lapsed in the year	**(288)**	(187)	**(224)**	(136)
Outstanding at 31 December	**5,532**	3,685	**4,466**	3,063

The weighted average remaining vesting period as at year end was 1.52 years (*2007: 1.50 years*).

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 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.

52 Risk Management *(continued)*

a *Credit risk*

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from lending, trade finance, treasury and leasing business, but also from off-balance sheet products such as guarantees and credit derivatives, and from the group's holding of debt securities. The group has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities. The group's principal credit risk management procedures and policies, which follow policies established by HSBC Group Head Office, include the following:

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

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

A separately convened Risk Management Committee ('RMC'), reporting to EXCO has the responsibility for exercising and delegating risk approval authorities, setting risk appetite and approving definitive risk policies and controls. It monitors risk inherent to the financial services business, receives reports, determines action to be taken and reviews the efficacy of risk management framework.

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

Credit quality

The group's credit risk rating system and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. For individually significant accounts, risk ratings are reviewed regularly and amendments, where necessary, are implemented promptly. Within the group's retail portfolios, risk is assessed and managed using a wide range of risk and pricing models.

Previously, the group has deployed a seven-grade rating system based on a composite assessment of the likelihood and extent of delinquency and risk mitigation.

52 Risk Management *(continued)*

This legacy risk rating scale has been superseded by a more sophisticated and granular methodology, based on probability of default and loss estimates, compliant with an internal rating-based ('IRB') approach required to support the Basel II framework for calculating the group's minimum capital requirement. The integration of this framework into the group's reporting structure will enable reporting on the new basis to internal management in accordance with the group's IRB obligations.

Collateral and other credit enhancements

Loans and advances

The group has guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and the determination of valuation parameters. Such parameters are expected to be conservative, reviewed regularly and supported by empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfil 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.

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*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**183**	208	**38**	61
Commercial and industrial properties	**99**	56	**85**	56
Other assets	**4**	3	**–**	–
	286	267	**123**	117

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).

Other financial assets

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

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

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

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.

Maximum exposure to credit risk

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

Group

	2008	2007
	HK$m	HK$m
Cash and short-term funds	**597,572**	794,923
Items in the course of collection from other banks	**13,949**	20,357
Placings with banks maturing after one month	**55,569**	60,328
Certificates of deposit	**57,078**	97,358
Hong Kong SAR Government certificates of indebtedness	**119,024**	108,344
Trading assets	**481,658**	327,143
Debt securities	**187,236**	173,067
Treasury bills	**238,778**	108,888
Other	**55,644**	45,188
Financial assets designated at fair value	**19,736**	19,607
Debt securities	**19,730**	19,589
Treasury bills	**–**	–
Other	**6**	18
Derivatives	**453,923**	180,440
Advances to customers	**1,286,145**	1,212,086
Financial investments: Debt securities	**549,520**	450,235
Amounts due from group companies	**378,662**	364,724
Other assets	**66,139**	60,002
Acceptances and endorsements	**31,453**	31,918
Other	**34,686**	28,084
Financial guarantees and other credit-related contingent liabilities	**97,046**	115,688
Loan commitments and other credit-related commitments	**1,302,304**	1,327,069
At 31 December	**5,478,325**	5,138,304

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

52 Risk Management *(continued)*

Bank

	2008	2007
	HK$m	HK$m
Cash and short-term funds	**481,702**	637,771
Items in the course of collection from other banks	**9,908**	13,946
Placings with banks maturing after one month	**33,754**	39,842
Certificates of deposit	**36,980**	48,788
Hong Kong SAR Government certificates of indebtedness	**119,024**	108,344
Trading assets	**317,841**	227,792
Debt securities	**147,381**	106,670
Treasury bills	**125,644**	102,169
Other	**44,816**	18,953
Financial assets designated at fair value	**1,728**	2,861
Debt securities	**1,722**	2,843
Other	**6**	18
Derivatives	**452,209**	178,184
Advances to customers	**817,996**	743,530
Financial investments: Debt securities	**311,412**	189,023
Amounts due from group companies	**397,961**	381,236
Other assets	**42,455**	41,572
Acceptances and endorsements	**26,006**	25,801
Other	**16,449**	15,771
Financial guarantees and other credit-related contingent liabilities	**83,039**	102,812
Loan commitments and other credit-related commitments	**954,725**	970,403
At 31 December	**4,060,734**	3,686,104

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

52 Risk Management *(continued)*

Credit quality of financial instruments

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

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

Quality Classification	*Wholesale lending and Derivatives*	*Retail lending*	*Debt securities/ other*
Strong	CRR 1 to CRR 2	EL 1 to EL 2	A– and above
Medium	CRR 3 to CRR 5	EL 3 to EL 5	B+ to BBB+, and unrated
Sub-standard	CRR 6 to CRR 8	EL 6 to EL 8	B and below
Impaired	CRR 9 to CRR 10	EL 9 to EL 10	Impaired

Quality classification definitions:

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

The group's policy in respect of impairment on loans and advances and debt securities is set out in note 4d and 4g on the Financial Statements. Analysis of impairment allowances as at 31 December 2008 and the movement of such allowances during the year are disclosed in note 18.

Granular risk rating scales:

The CRR ('Customer Risk Rating') 10-grade scale maps to a more granular underlying 22-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/ product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

The basis of reporting has been changed from previous years in order to reflect the risk rating systems introduced under the Group's Basel II programme and to extend the range of financial instruments covered in the presentation of portfolio quality.

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

52 Risk Management *(continued)*

Distribution of financial instruments by credit quality

Group	*Neither past due nor impaired*						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Items in the course of collection from other banks	**12,344**	**1,605**	**–**	**–**	**–**	**–**	**13,949**
Trading assets	**443,134**	**34,804**	**563**	**3,157**	**–**	**–**	**481,658**
– treasury and other eligible bills	**238,083**	**533**	**162**	**–**	**–**	**–**	**238,778**
– debt securities	**159,247**	**27,946**	**43**	**–**	**–**	**–**	**187,236**
– loans and advances to banks	**38,506**	**2,230**	**356**	**3,157**	**–**	**–**	**44,249**
– loans and advances to customers	**7,298**	**4,095**	**2**	**–**	**–**	**–**	**11,395**
Financial assets designated at fair value	**18,209**	**1,527**	**–**	**–**	**–**	**–**	**19,736**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**18,209**	**1,521**	**–**	**–**	**–**	**–**	**19,730**
– loans and advances to banks	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– loans and advances to customers	**–**	**6**	**–**	**–**	**–**	**–**	**6**
Derivatives	**375,566**	**73,558**	**4,761**	**1**	**37**	**–**	**453,923**
Loans and advances held at amortised cost	**1,058,105**	**557,570**	**31,752**	**28,896**	**13,080**	**(10,958)**	**1,678,445**
– loans and advances to banks	**364,370**	**26,070**	**1,543**	**317**	**–**	**–**	**392,300**
– loans and advances to customers	**693,735**	**531,500**	**30,209**	**28,579**	**13,080**	**(10,958)**	**1,286,145**
Financial investments	**667,162**	**70,624**	**–**	**251**	**212**	**–**	**738,249**
– treasury and other eligible bills	**120,458**	**11,193**	**–**	**–**	**–**	**–**	**131,651**
– debt securities	**546,704**	**59,431**	**–**	**251**	**212**	**–**	**606,598**
Other assets	**19,682**	**44,035**	**1,986**	**386**	**50**	**–**	**66,139**
– endorsements and acceptances	**7,044**	**22,888**	**1,365**	**142**	**14**	**–**	**31,453**
– other	**12,638**	**21,147**	**621**	**244**	**36**	**–**	**34,686**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Group	*Neither past due nor impaired*						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2007	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Items in the course of collection from other banks	18,638	1,719	–	–	–	–	20,357
Trading assets	278,210	48,839	71	23	–	–	327,143
– treasury and other eligible bills	105,592	3,296	–	–	–	–	108,888
– debt securities	138,477	34,566	24	–	–	–	173,067
– loans and advances to banks	31,736	2,609	42	23	–	–	34,410
– loans and advances to customers	2,405	8,368	5	–	–	–	10,778
Financial assets designated at fair value	17,091	2,516	–	–	–	–	19,607
– treasury and other eligible bill	–	–	–	–	–	–	–
– debt securities	17,091	2,498	–	–	–	–	19,589
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	18	–	–	–	–	18
Derivatives	155,402	23,985	1,053	–	–	–	180,440
Loans and advances held at amortised cost	1,261,870	564,041	31,219	32,375	8,383	(7,260)	1,890,628
– loans and advances to banks	600,424	73,426	4,518	174	–	–	678,542
– loans and advances to customers	661,446	490,615	26,701	32,201	8,383	(7,260)	1,212,086
Financial investments	641,733	69,394	–	346	–	–	711,473
– treasury and other eligible bills	153,536	10,344	–	–	–	–	163,880
– debt securities	488,197	59,050	–	346	–	–	547,593
Other assets	22,895	34,901	1,819	301	86	–	60,002
– endorsements and acceptances	9,213	21,234	1,242	152	77	–	31,918
– other	13,682	13,667	577	149	9	–	28,084

52 Risk Management *(continued)*

Bank	*Neither past due nor impaired*						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Items in the course of collection from other banks	**8,304**	**1,604**	**–**	**–**	**–**	**–**	**9,908**
Trading assets	**283,435**	**30,686**	**563**	**3,157**	**–**	**–**	**317,841**
– treasury and other eligible bills	**124,949**	**533**	**162**	**–**	**–**	**–**	**125,644**
– debt securities	**123,492**	**23,846**	**43**	**–**	**–**	**–**	**147,381**
– loans and advances to banks	**27,709**	**2,230**	**356**	**3,157**	**–**	**–**	**33,452**
– loans and advances to customers	**7,285**	**4,077**	**2**	**–**	**–**	**–**	**11,364**
Financial assets designated at fair value	**1,143**	**585**	**–**	**–**	**–**	**–**	**1,728**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**1,143**	**579**	**–**	**–**	**–**	**–**	**1,722**
– loans and advances to banks	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– loans and advances to customers	**–**	**6**	**–**	**–**	**–**	**–**	**6**
Derivatives	**376,678**	**70,807**	**4,686**	**1**	**37**	**–**	**452,209**
Loans and advances held at amortised cost	**674,425**	**374,986**	**21,967**	**18,486**	**8,718**	**(8,292)**	**1,090,290**
– loans and advances to banks	**249,332**	**21,103**	**1,543**	**316**	**–**	**–**	**272,294**
– loans and advances to customers	**425,093**	**353,883**	**20,424**	**18,170**	**8,718**	**(8,292)**	**817,996**
Financial investments	**408,911**	**57,189**	**–**	**251**	**39**	**–**	**466,390**
– treasury and other eligible bills	**106,841**	**11,157**	**–**	**–**	**–**	**–**	**117,998**
– debt securities	**302,070**	**46,032**	**–**	**251**	**39**	**–**	**348,392**
Other assets	**12,938**	**27,716**	**1,644**	**117**	**40**	**–**	**42,455**
– endorsements and acceptances	**6,186**	**18,475**	**1,218**	**117**	**10**	**–**	**26,006**
– other	**6,752**	**9,241**	**426**	**–**	**30**	**–**	**16,449**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Bank	*Neither past due nor impaired*						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2007	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Items in the course of collection from other banks	12,332	1,614	–	–	–	–	13,946
Trading assets	194,716	32,982	71	23	–	–	227,792
– treasury and other eligible bills	98,873	3,296	–	–	–	–	102,169
– debt securities	78,225	28,421	24	–	–	–	106,670
– loans and advances to banks	16,304	317	42	23	–	–	16,686
– loans and advances to customers	1,314	948	5	–	–	–	2,267
Financial assets designated at fair value	1,498	1,363	–	–	–	–	2,861
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	1,498	1,345	–	–	–	–	2,843
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	18	–	–	–	–	18
Derivatives	154,309	22,826	1,049	–	–	–	178,184
Loans and advances held at amortised cost	835,777	371,105	21,644	22,083	6,539	(5,724)	1,251,424
– loans and advances to banks	442,897	60,357	4,466	174	–	–	507,894
– loans and advances to customers	392,880	310,748	17,178	21,909	6,539	(5,724)	743,530
Financial investments	349,394	48,810	–	346	–	–	398,550
– treasury and other eligible bills	150,495	10,244	–	–	–	–	160,739
– debt securities	198,899	38,566	–	346	–	–	237,811
Other assets	13,623	26,117	1,637	109	86	–	41,572
– endorsements and acceptances	7,965	16,531	1,119	109	77	–	25,801
– other	5,658	9,586	518	–	9	–	15,771

52 Risk Management *(continued)*

Financial instruments which were past due but not impaired aging analysis

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

Group

	Up to 29 days	*30-59 days*	*60-89 days*	*90-180 days*	*Over 180 days*	*Total*
31 December 2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	**3,129**	**28**	–	–	–	**3,157**
– loans and advances to banks	**3,129**	**28**	–	–	–	**3,157**
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	**1**	–	–	–	–	**1**
Loans and advances held at amortised cost	**22,292**	**3,777**	**1,975**	**736**	**116**	**28,896**
– loans and advances to banks	**317**	–	–	–	–	**317**
– loans and advances to customers[1]	**21,975**	**3,777**	**1,975**	**736**	**116**	**28,579**
Financial investments	**251**	–	–	–	–	**251**
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	**251**	–	–	–	–	**251**
Other assets	**108**	**127**	**78**	**45**	**28**	**386**
	25,781	**3,932**	**2,053**	**781**	**144**	**32,691**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Group

31 December 2007	*Up to 29 days* HK$m	*30-59 days* HK$m	*60-89 days* HK$m	*90-180 days* HK$m	*Over 180 days* HK$m	*Total* HK$m
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	23	–	–	–	–	23
– loans and advances to banks	23	–	–	–	–	23
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost	26,700	2,964	1,878	524	309	32,375
– loans and advances to banks	174	–	–	–	–	174
– loans and advances to customers[1]	26,526	2,964	1,878	524	309	32,201
Financial investments	346	–	–	–	–	346
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	346	–	–	–	–	346
Other assets	128	64	54	31	24	301
	27,197	3,028	1,932	555	333	33,045

52 Risk Management *(continued)*

Bank

31 December 2008	*Up to 29 days* HK$m	*30-59 days* HK$m	*60-89 days* HK$m	*90-180 days* HK$m	*Over 180 days* HK$m	*Total* HK$m
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	**3,129**	**28**	–	–	–	**3,157**
– loans and advances to banks	**3,129**	**28**	–	–	–	**3,157**
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	**1**	–	–	–	–	**1**
Loans and advances held at amortised cost	**14,404**	**2,249**	**1,387**	**396**	**50**	**18,486**
– loans and advances to banks	**316**	–	–	–	–	**316**
– loans and advances to customers[1]	**14,088**	**2,249**	**1,387**	**396**	**50**	**18,170**
Financial investments	**251**	–	–	–	–	**251**
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	**251**	–	–	–	–	**251**
Other assets	**73**	**30**	–	**13**	**1**	**117**
	17,858	**2,307**	**1,387**	**409**	**51**	**22,012**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Bank

31 December 2007	*Up to 29 days* HK$m	*30-59 days* HK$m	*60-89 days* HK$m	*90-180 days* HK$m	*Over 180 days* HK$m	*Total* HK$m
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	23	–	–	–	–	23
– loans and advances to banks	23	–	–	–	–	23
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost	18,739	2,094	835	261	154	22,083
– loans and advances to banks	174	–	–	–	–	174
– loans and advances to customers[1]	18,565	2,094	835	261	154	21,909
Financial investments	346	–	–	–	–	346
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	346	–	–	–	–	346
Other assets	84	21	–	2	2	109
	19,192	2,115	835	263	156	22,561

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

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 2008 and the movement of such allowances during the year are disclosed in note 18.

52 Risk Management *(continued)*

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 the Asset and Liability Management 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;
- managing contingent liquidity commitment exposures within pre-determined limits;
- maintaining debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Current accounts and savings deposits payable on demand or at short notice form a significant part of 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.

52 Risk Management *(continued)*

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 ratio of the reported group net liquid assets to customer liabilities as at the reporting date and during the reporting period were as follows:

	2008	2007
	%	%
At 31 December	**25.0**	21.8
Average for the period	**21.9**	20.5
Maximum for the period	**25.0**	24.1
Minimum for the period	**19.9**	16.1

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.

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.

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence (99 per cent for the group). VAR is calculated daily.

The group uses a historical simulation model which derives plausible future scenarios from historical market data. Potential movements in market prices are calculated with reference to market data from the last two years. The model used assumes a 1-day holding period, as this reflects the way the risk positions are managed.

Although a valuable guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;

- the use of a 1-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a 1-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

The group recognises these limitations by augmenting the VAR limits with other position and sensitivity limit structures, as well as with stress testing, both on individual portfolios and on a consolidated basis. The group's stress testing regime provides senior management with an assessment of the impact of extreme events on the market risk exposures of the group.

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.

52 Risk Management *(continued)*

The total VAR for Global Markets was as follows:

	Group		*Bank*	
	2008	2007	**2008**	2007
	HK$m	HK$m	**HK$m**	HK$m
Total VAR				
Year end	**210**	180	**206**	157
Average	**191**	146	**165**	120
Maximum	**288**	213	**213**	173
Minimum	**122**	99	**120**	83
Total interest rate VAR				
Year end	**193**	162	**198**	137
Average	**184**	137	**161**	110
Maximum	**291**	209	**212**	174
Minimum	**121**	92	**123**	79
Trading VAR[1]				
Year end	**132**	93	**112**	91
Average	**121**	69	**114**	73
Maximum	**179**	121	**180**	119
Minimum	**80**	35	**75**	35
Total Foreign exchange VAR				
Year end	**44**	10	**42**	13
Average	**24**	18	**24**	13
Maximum	**45**	40	**42**	33
Minimum	**8**	5	**10**	6
Foreign exchange trading VAR				
Year end	**35**	20	**46**	21
Average	**23**	18	**22**	16
Maximum	**37**	39	**46**	28
Minimum	**10**	4	**12**	4
Interest rate trading VAR[1]				
Year end	**97**	84	**96**	68
Average	**112**	53	**105**	60
Maximum	**173**	87	**146**	87
Minimum	**73**	30	**66**	28
Equity trading VAR[2]				
Year end	**56**	58	**56**	58
Average	**43**	38	**43**	38
Maximum	**97**	100	**97**	100
Minimum	**17**	14	**17**	14

1 *The definition of Trading VAR and Interest rate trading VAR has been amended to apply trading intent VAR (excluding trading in accrual position). Therefore, the 2007 figures have been amended to reflect this.*

2 *In addition to equity trading positions managed by Global Markets, the Bank also has exposure to changes in equity prices and interest rate relating to guarantees given to customers who purchase certain HSBC investment contracts. As at 31 December 2008, a 10 per cent decrease in equity prices would reduce profit before tax and net assets by HK$113 million (2007: HK$54 million) and 100 basis points decrease in interest rate would reduce profit before tax and net assets by HK$51 million (2007: HK$41 million).*

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$157,308 million (81 per cent of shareholders' funds) at 31 December 2008, a decrease of HK$22,022 million from HK$179,330 million (81 per cent of shareholders' funds) at 31 December 2007. Gains or losses on structural foreign currency exposures are taken to reserves.

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 2008	**LCYm**	**HK$m**	**LCYm**	**HK$m**
Chinese renminbi	**73,792**	**83,819**	**23,812**	**27,048**
Indian rupees	**133,870**	**21,339**	**105,420**	**16,804**
Korean won	**1,593,044**	**9,802**	**1,469,202**	**9,040**

	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

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 2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Spot assets	**2,947,677**	**113,295**	**73,565**	**97,229**
Spot liabilities	**(2,922,971)**	**(168,458)**	**(26,390)**	**(77,588)**
Forward purchases	**3,127,618**	**292,172**	**131**	**406,545**
Forward sales	**(3,160,163)**	**(234,203)**	**(50,115)**	**(428,163)**
Net options positions	**19,173**	**(12)**	**–**	**–**
	11,334	**2,794**	**(2,809)**	**(1,977)**

	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 positions	18,068	–	–	–
	3,723	6,318	(6,188)	(1,886)

Bank

	United States dollars	*Singapore dollars*	*Brunei dollars*	*Chinese Renminbi*
	HK$m	**HK$m**	**HK$m**	**HK$**
At 31 December 2008	**812**	**2,797**	**(2,809)**	**4,521**
At 31 December 2007	(6,226)	6,327	(6,188)	5,173

The net options positions 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 learnt from publicised operational failures within the financial services industry.

The HSBC Group has codified its operational risk management process by issuing a high level standard, supplemented by more detailed formal guidance. This explains how the group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The standard covers the following:

- operational risk management responsibility is assigned to senior management within the business operation;
- information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting;
- assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;
- operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the HSBC Group's Audit Committee; and
- risk mitigation, including insurance, is considered where this is cost-effective.

The group maintains and tests contingency facilities to support operations in the event of disasters.

Additional reviews and tests are conducted in the event that any HSBC office is affected by a business disruption event, to incorporate lessons learnt in the operational recovery from those circumstances. Plans have been prepared for the continued operation of the group's business, with reduced staffing levels, should a flu pandemic occur.

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e *Insurance risk*

Risk management objectives and policies for management of insurance risk

The group is exposed to the uncertainty surrounding the timing and severity of claims under insurance contracts. Contracts under which the group accepts significant insurance risk from another party by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event adversely affects the policyholder or other beneficiary are classified as insurance contracts. Contracts under which the transfer of insurance risk from the policyholder to the group is not significant are classified as investment contracts or service contracts. Insurance risk is risk other than financial risk. Insurance contracts may also transfer some financial risk. Details of financial risk are disclosed below.

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

The group uses several methods to assess and monitor insurance risk exposures both for individual types of risks insured and overall risks. These methods include internal risk measurement models, sensitivity analyses, scenario analyses and stress testing.

The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. The principal risk is that the frequency and severity of claims is greater than expected. Insurance events are, by their nature, random, and the actual number of events during any one year may vary from those estimated using established statistical techniques.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Asset/liability management

The group actively manages its assets using an approach that considers asset quality, diversification, asset/liability matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Markets and Liquidity Risk Committee reviews and approves target portfolios on a periodic basis, establishes investment guidelines and limits, and provides oversight of the asset/liability management process.

The group establishes target asset portfolios for each major insurance product category consistent with local regulatory requirements. The investment strategy and asset allocations consider yield, duration, sensitivity, market risk, volatility, liquidity, asset concentration, foreign exchange and credit quality. The estimates and assumptions used in determining the approximate amounts and timing of payments to or on behalf of policyholders for insurance liabilities are regularly re-evaluated. Many of these estimates and assumptions are inherently subjective and could impact the group's ability to achieve its asset/liability management goals and objectives.

The following table shows the composition of assets and liabilities for each major insurance product category. 95% of both assets and liabilities are derived from Hong Kong.

Balance sheet of insurance subsidiaries by type of contract

	Life linked contracts[1] HK$m	*Life non-linked contracts*[2] HK$m	*Non-life insurance*[3] HK$m	*Other assets*[4] HK$m	*Total* HK$m
At 31 December 2008					
Financial assets:					
– financial assets designated at fair value	**16,130**	**16,875**	**213**	**3,469**	**36,687**
– derivatives	**5**	**900**	**–**	**–**	**905**
– financial investments	**–**	**77,402**	**1,369**	**4,775**	**83,546**
– other financial assets	**2,365**	**20,211**	**914**	**1,276**	**24,766**
Total financial assets	**18,500**	**115,388**	**2,496**	**9,520**	**145,904**
Reinsurance assets	**7,334**	**144**	**361**	**101**	**7,940**
PVIF[5]	**–**	**–**	**–**	**7,638**	**7,638**
Other assets	**7**	**1,304**	**129**	**1,738**	**3,178**
Total assets	**25,841**	**116,836**	**2,986**	**18,997**	**164,660**
Liabilities under investment contracts designated at fair value	**5,707**	**25,083**	**–**	**–**	**30,790**
Liabilities under insurance contacts	**20,044**	**90,643**	**2,602**	**–**	**113,289**
Deferred tax	**52**	**115**	**–**	**1,229**	**1,396**
Other liabilities	**–**	**–**	**–**	**1,805**	**1,805**
Total liabilities	**25,803**	**115,841**	**2,602**	**3,034**	**147,280**
Total equity	**–**	**–**	**–**	**17,380**	**17,380**
Total equity and liabilities	**25,803**	**115,841**	**2,602**	**20,414**	**164,660**

	Life linked contracts[1] HK$m	*Life non-linked contracts*[2] HK$m	*Non-life insurance*[3] HK$m	*Other assets*[4] HK$m	*Total* HK$m
At 31 December 2007					
Financial assets:					
– financial assets designated at fair value	24,793	32,703	229	989	58,714
– derivatives	–	34	–	1	35
– financial investments	–	44,132	1,133	5,952	51,217
– other financial assets	3,138	20,464	1,036	2,653	27,291
Total financial assets	27,931	97,333	2,398	9,595	137,257
Reinsurance assets	9	51	430	94	584
PVIF[5]	–	–	–	6,824	6,824
Other assets	9	852	127	490	1,478
Total assets	27,949	98,236	2,955	17,003	146,143
Liabilities under investment contracts designated at fair value	8,410	25,382	–	–	33,792
Liabilities under insurance contacts	19,380	69,687	2,532	–	91,599
Deferred tax	43	49	3	1,114	1,209
Other liabilities	–	–	–	1,853	1,853
Total liabilities	27,833	95,118	2,535	2,967	128,453
Total equity	–	–	–	17,690	17,690
Total equity and liabilities	27,833	95,118	2,535	20,657	146,143

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

Underwriting strategy

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

Reinsurance strategy

The group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. The group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured so that it falls within specified insurance risk appetite. The group also utilises reinsurance to transfer out financial risk arising from guaranteeing minimum investment performance under a specific unit-linked insurance product, and uses reinsurance agreements with both affiliated and non-affiliated reinsurers to control its exposure to losses resulting from certain catastrophes.

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

52 Risk Management *(continued)*

Nature of risks covered

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

(i) Insurance contracts – non-linked products

The basic feature of long-term non-linked insurance business is to provide guaranteed death benefit determined at the time of policy issue. For non-linked insurance products with a savings element, guaranteed surrender benefit, guaranteed maturity benefit, crediting rate guarantees and/or non-lapse guarantee features may be provided. Discretionary participation features allow policyholders to participate in the profits of the life fund by means of annual bonuses. The group has complete contractual discretion on the bonuses declared. It is the group's goal to maintain a smooth dividend scale based on the long-term rate of return. Annual reviews are performed to confirm whether the current dividend scale is supportable.

(ii) Insurance contracts – unit-linked products

The group writes unit-linked life insurance policies, which typically provide policyholders with life insurance protection and choice of investment in a variety of funds. Premiums received are deposited into the chosen funds after deduction of premium fees. Other charges for the cost of insurance and administration are deducted from the funds accumulated. Where policyholders bear the market risk on linked products that enjoy no performance guarantees, the group manages the policyholders' exposure to market risk in a manner consistent with any parameters set out in the policy documents. Where there is a performance guarantee, the risk is managed through reinsurance.

(iii) Investment contracts – non-linked return guaranteed products

The group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the group provides an investment return guarantee for some specific funds. The guarantee risks are managed through investment in fixed rate bonds. Investment strategy is set with the objective of providing a return that is sufficient to meet at least the minimum guarantee.

(iv) Investment contracts – unit-linked products

The group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the group does not bear investment risk for most of the funds. Although scheme members bear the market risk on the funds, the group manages the scheme members' exposure to market risk in a manner consistent with any parameters set out in the policy documents.

(v) Non-life insurance contracts

The group assumes the risk of loss from persons and organisations that are directly subject to the risk. Such risk may relate to property, liability, life, accident, health, financial or other perils that may arise from an insurable event. The group manages the risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set authority limits, risk diversification, underwriting guidelines, reinsurance and centralised management of reinsurance and monitoring of emerging issues. The group also assesses and monitors insurance risk exposures both for individual types of risks insured and overall risks.

52 Risk Management *(continued)*

Concentrations of insurance risks

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

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

For contracts where death is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics (such as AIDS, SARS or a human form of avian flu) or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. For contracts where survival is the insurance risk, the most significant factor is improvement in medical science and social conditions that would increase longevity. The policyholders of the insurance contracts issued by the group are mainly residents of Hong Kong, Macau, Taiwan, Singapore, Malaysia, India and South Korea.

To determine the concentration of insurance risks and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the group. Total loss is estimated based on the chosen stress level. Details of the group's reinsurance strategy are disclosed in page 184.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. By definition, the group is not exposed to insurance risk on investment contracts, so they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 33. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

Analysis of non-life insurance risk – net written insurance premiums[1]

	2008	2007
	HK$m	HK$m
Accident and health	**1,244**	1,058
Fire and other damage	**227**	226
Motor	**220**	192
Liability	**136**	123
Marine, aviation and transport	**116**	117
Other (non-life)	**287**	296
Total net written insurance premiums	**2,230**	2,012

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

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Financial risks

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

The group is also exposed to investment return guarantee risk for certain investment contracts issued to policyholders for its long-term insurance business. The risk is that the yield on the assets held by the group to meet these guarantees may fall short of the guaranteed return. The framework for the management of this risk is to adopt a matching approach whereby assets held are managed to meet the liability to policyholders. An additional provision is established where analysis indicates that, over the life of the contracts, the returns from the designated assets may not be adequate to cover the related liabilities.

The following table analyses the assets held in the group's insurance underwriting subsidiaries at 31 December 2008 by type of liability, and provides a view of the exposure to financial risk:

Financial assets held by insurance manufacturing operations

	At 31 December 2008				
	Life linked contracts	*Life non-linked contracts*	*Non-life insurance*	*Other assets*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Financial assets designated at fair value					
Debt securities	**196**	**13,301**	**213**	**3,469**	**17,179**
Equity securities	**15,934**	**3,574**	**–**	**–**	**19,508**
	16,130	**16,875**	**213**	**3,469**	**36,687**
Financial investments					
Held-to-maturity:					
Debt securities	**–**	**76,699**	**1,320**	**3,954**	**81,973**
	–	**76,699**	**1,320**	**3,954**	**81,973**
Available-for-sale:					
Treasury bills	**–**	**34**	**49**	**–**	**83**
Debt securities	**–**	**669**	**–**	**281**	**950**
Equity securities	**–**	**–**	**–**	**540**	**540**
	–	**703**	**49**	**821**	**1,573**
Derivatives	**5**	**900**	**–**	**–**	**905**
Other financial assets	**2,365**	**20,211**	**914**	**1,276**	**24,766**
	18,500	**115,388**	**2,496**	**9,520**	**145,904**

52 Risk Management *(continued)*

Financial assets held by insurance manufacturing operations

	At 31 December 2007				
	Life linked contracts HK$m	*Life non-linked contracts* HK$m	*Non-life insurance* HK$m	*Other assets* HK$m	*Total* HK$m
Financial assets designated at fair value					
Debt securities	202	14,167	179	960	15,508
Equity securities	24,591	18,536	50	29	43,206
	24,793	32,703	229	989	58,714
Financial investments					
Held-to-maturity:					
Debt securities	–	43,794	1,121	3,181	48,096
	–	43,794	1,121	3,181	48,096
Available-for-sale:					
Treasury bills	–	16	12	–	28
Debt securities	–	322	–	514	836
Equity securities	–	–	–	2,257	2,257
	–	338	12	2,771	3,121
Derivatives	–	34	–	1	35
Other financial assets	3,138	20,464	1,036	2,653	27,291
	27,931	97,333	2,398	9,595	137,257

The table demonstrates that for linked contracts, the group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 12.7 per cent of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2008 (*2007: 20.3 per cent*). The table also shows that approximately 68.6 per cent of financial assets were invested in debt securities at 31 December 2008 (*2007: 46.9 per cent*) with 13.7 per cent (*2007: 33.1 per cent*) invested in equity securities.

Market risk

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

Interest rate risk

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

For participating products, interest rate risk related to non-linked policies can also be mitigated through sharing of risk with policyholders under the discretionary participation mechanism.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

A shift in interest yield curves as at 31 December 2008 in all territories in which the group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

	31 December 2008		31 December 2007	
	Impact on profit for the year	*Impact on net assets*	*Impact on profit for the year*	*Impact on net assets*
	HK$m	**HK$m**	HK$m	HK$m
+ 100 basis points shift in yield curves	**384**	**370**	528	511
– 100 basis points shift in yield curves	**(227)**	**(213)**	(603)	(585)

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

Equity risk

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

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

	31 December 2008		31 December 2007	
	Impact on profit for the year	*Impact on net assets*	*Impact on profit for the year*	*Impact on net assets*
	HK$m	**HK$m**	HK$m	HK$m
10 per cent increase in equity prices	**43**	**43**	1,017	1,042
10 per cent decrease in equity prices	**(43)**	**(43)**	(1,017)	(1,042)

The substantial decrease in the impact to profit and net assets for 2008 was attributable to the group's reduced equity exposures for non-linked contracts.

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

Foreign currency risk

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

52 Risk Management *(continued)*

Credit risk

The group's portfolio of fixed income securities, and to a lesser extent short-term and other investments are subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place. Limits are established to manage credit quality and concentration risk. The following table presents the analysis of the treasury bills, other eligible bills and debt securities within the group's insurance business.

	Neither past due nor impaired						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value	**12,694**	**820**	–	–	–	–	**13,514**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	12,694	820	–	–	–	–	13,514
Financial investments	**78,361**	**410**	–	–	–	–	**78,771**
– treasury and other eligible bills	83	–	–	–	–	–	83
– debt securities	78,278	410	–	–	–	–	78,688
Supporting shareholders funds							
Financial assets designated at fair value	**3,464**	**5**	–	–	–	–	**3,469**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	3,464	5	–	–	–	–	3,469
Financial investments	**4,218**	**17**	–	–	–	–	**4,235**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	4,218	17	–	–	–	–	4,235
Total							
Financial assets designated at fair value	**16,158**	**825**	–	–	–	–	**16,983**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	16,158	825	–	–	–	–	16,983
Financial investments	**82,579**	**427**	–	–	–	–	**83,006**
– treasury and other eligible bills	83	–	–	–	–	–	83
– debt securities	82,496	427	–	–	–	–	82,923

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

	Neither past due nor impaired						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2007	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value	13,288	1,058	–	–	–	–	14,346
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,288	1,058	–	–	–	–	14,346
Financial investments	44,588	677	–	–	–	–	45,265
– treasury and other eligible bills	–	28	–	–	–	–	28
– debt securities	44,588	649	–	–	–	–	45,237
Supporting shareholders funds							
Financial assets designated at fair value	917	43	–	–	–	–	960
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	917	43	–	–	–	–	960
Financial investments	3,342	353	–	–	–	–	3,695
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	3,342	353	–	–	–	–	3,695
Total							
Financial assets designated at fair value	14,205	1,101	–	–	–	–	15,306
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	14,205	1,101	–	–	–	–	15,306
Financial investments	47,930	1,030	–	–	–	–	48,960
– treasury and other eligible bills	–	28	–	–	–	–	28
– debt securities	47,930	1,002	–	–	–	–	48,932

52 Risk Management *(continued)*

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

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
31 December 2008							
Linked insurance contracts	**1**	**7,333**	**–**	**–**	**–**	**–**	**7,334**
Non-linked insurance contracts	**450**	**55**	**–**	**–**	**–**	**–**	**505**
Total	**451**	**7,388**	**–**	**–**	**–**	**–**	**7,839**
Reinsurance debtors	**17**	**2**	**–**	**82**	**–**	**–**	**101**
31 December 2007							
Linked insurance contracts	9	–	–	–	–	–	9
Non-linked insurance contracts	432	49	–	–	–	–	481
Total	441	49	–	–	–	–	490
Reinsurance debtors	47	4	–	44	–	–	95

The group has sold a unit-linked life insurance product which provides guaranteed minimum death benefits and guaranteed minimum accumulated benefits which are underwritten by the group but reinsured by a third party. The group has a credit risk exposure in respect of the third party's ability to meet its reinsurance obligation. At 31 December 2008, the exposure to the third party was HK$7,333 million (*2007: HK$nil*).

Liquidity risk

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

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

The following table shows the expected maturity of insurance contract liabilities at 31 December 2008:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year	*1-5 years*	*5-15 years*	*Over 15 years*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2008					
Non-life insurance	**1,551**	**831**	**221**	**–**	**2,603**
Life insurance (non-linked)	**7,814**	**46,947**	**112,193**	**87,843**	**254,797**
Life insurance (linked)	**8,561**	**4,596**	**12,543**	**32,126**	**57,826**
	17,926	**52,374**	**124,957**	**119,969**	**315,226**
At 31 December 2007					
Non-life insurance	1,458	789	285	–	2,532
Life insurance (non-linked)	6,018	28,738	105,913	78,254	218,923
Life insurance (linked)	2,256	7,194	13,893	30,517	53,860
	9,732	36,721	120,091	108,771	275,315

Remaining contractual maturity of investment contract liabilities

	Linked investment contracts	*Non-linked investment contracts*	*Investment contracts with DPF*	*Total*
At 31 December 2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Remaining contractual maturity				
– due within 1 year	**59**	**235**	**4**	**298**
– due between 1 and 5 years	**–**	**165**	**256**	**421**
– due between 5 and 10 years	**–**	**237**	**–**	**237**
– due after 10 years	**82**	**327**	**–**	**409**
– undated	**5,566**	**24,119**	**–**	**29,685**
	5,707	**25,083**	**260**	**31,050**
At 31 December 2007				
Remaining contractual maturity				
– due within 1 year	76	146	4	226
– due between 1 and 5 years	–	367	222	589
– due between 5 and 10 years	–	–	–	–
– due after 10 years	122	345	–	467
– undated	8,212	24,524	–	32,736
	8,410	25,382	226	34,018

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

The group's life insurance business is accounted for using the embedded value approach, which, *inter alia*, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2008 was HK$7,638 million (*2007: HK$6,824 million*). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2008 can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

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

The following table shows the effect on the PVIF as at 31 December 2008 of reasonably possible changes in the main economic and business assumptions:

	Impact on 2008 results **HK$m**	*Impact on 2007 results* HK$m
+ 100 basis points shift in risk-free rate	**1,155**	1,324
– 100 basis points shift in risk-free rate	**(561)**	(1,437)
+ 100 basis points shift in risk discount rate	**(492)**	(362)
– 100 basis points shift in risk discount rate	**564**	412
+ 100 basis points shift in expenses inflation	**(24)**	(27)
– 100 basis points shift in expenses inflation	**21**	24
+ 100 basis points shift in lapse rate	**1,207**	906
– 100 basis points shift in lapse rate	**(1,181)**	(942)

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

Non-economic assumptions

The sensitivity of profit for the year and net assets to reasonably possible changes in conditions at 31 December 2008 across all insurance underwriting subsidiaries is as follows:

	Impact on 2008 results		*Impact on 2007 results*	
	Profit after tax **HK$m**	*Net assets* **HK$m**	*Profit after tax* HK$m	*Net assets* HK$m
20 per cent increase in claims costs	**(192)**	**(192)**	(79)	(79)
20 per cent decrease in claims costs	**192**	**192**	79	79
10 per cent increase in mortality and/or morbidity rates	**(123)**	**(123)**	(154)	(154)
10 per cent decrease in mortality and/or morbidity rates	**121**	**121**	154	154
50 per cent increase in lapse rates	**559**	**559**	517	517
50 per cent decrease in lapse rates	**(423)**	**(423)**	(423)	(423)
10 per cent increase in expense rates	**(92)**	**(92)**	(96)	(96)
10 per cent decrease in expense rates	**92**	**92**	96	96

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.

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.

52 Risk Management *(continued)*

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 group continued to use the standardised approach to calculate operational risk and market risk. It also continues to apply an internal model approach to calculate the general market risk and a separate model to determine the market risk relating to equity options. However, as opposed to the standardised approach that was used at 31 December 2007, the group has adopted the foundation internal ratings-based approach to determine credit risk for 2008.

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 Impact of market turmoil

a *Holdings of asset-backed securities*

The group has holdings of asset-backed securities ('ABSs'), including those represented by mortgage-backed securities ('MBSs') and by collateralised debt obligations ('CDOs').

The table below shows the group's exposure to ABSs issued by entities which are not consolidated by any HSBC Group entities. The carrying amounts of these exposures are measured at fair value.

Group

	Gross principal[1]	*CDS Gross protection*[2]	*Net principal exposure*[3]	*Carrying amount*[4]
2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Sub-prime residential mortgage related assets				
MBSs and MBS CDOs				
– high grade (AA or AAA rated)	**1,192**	**–**	**1,192**	**411**
– C to A rated	**2,439**	**–**	**2,439**	**36**
	3,631	**–**	**3,631**	**447**
US government-sponsored enterprises' mortgage related assets				
MBSs				
– high grade (AA or AAA rated)	**6,092**	**–**	**6,092**	**6,116**
Other residential mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	**4,770**	**–**	**4,770**	**4,266**
– not publicly rated	**13**	**–**	**13**	**–**
	4,783	**–**	**4,783**	**4,266**
Commercial property mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	**603**	**–**	**603**	**595**
– C to A rated	**25**	**–**	**25**	**25**
– not publicly rated	**3**	**–**	**3**	**–**
	631	**–**	**631**	**620**
Leverage finance-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**152**	**–**	**152**	**91**
Student loan-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**2,037**	**–**	**2,037**	**1,934**
– not publicly rated	**7**	**–**	**7**	**–**
	2,044	**–**	**2,044**	**1,934**
Other assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**1,168**	**–**	**1,168**	**1,116**
– C to A rated	**1,360**	**(1,352)**	**8**	**1**
– not publicly rated	**280**	**(232)**	**48**	**–**
	2,808	**(1,584)**	**1,224**	**1,117**
	20,141	**(1,584)**	**18,557**	**14,591**

Notes on the Financial Statements (continued)

53 Impact of market turmoil *(continued)*

Group

2007	*Gross principal*[1] HK$m	*CDS Gross protection*[2] HK$m	*Net principal exposure*[3] HK$m	*Carrying amount*[4] HK$m
Sub-prime residential mortgage related assets				
MBSs and MBS CDOs				
– high grade (AA or AAA rated)	4,476	(2,846)	1,630	1,310
– C to A rated	1,591	(1,450)	141	101
	6,067	(4,296)	1,771	1,411
US government-sponsored enterprises' mortgage related assets				
MBSs				
– high grade (AA or AAA rated)	1,567	–	1,567	1,575
Other residential mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	9,927	–	9,927	9,974
Commercial property mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	468	–	468	468
– C to A rated	23	–	23	23
	491	–	491	491
Leverage finance related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	156	–	156	148
Student loan-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	2,262	–	2,262	2,246
Other assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	405	–	405	398
– C to A rated	2,028	(2,020)	8	8
– not publicly rated	1,224	–	1,224	967
	3,657	(2,020)	1,637	1,373
	24,127	(6,316)	17,811	17,218

53 Impact of market turmoil *(continued)*

The table below shows the geographic distribution of the group's exposures to ABSs shown above.

	Gross principal[1]	*CDS Gross protection*[2]	*Net principal exposure*[3]	*Carrying amount*[4]
2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**
US	**11,962**	**–**	**11,962**	**8,539**
UK	**1,463**	**–**	**1,463**	**1,022**
Rest of the world	**6,716**	**(1,584)**	**5,132**	**5,030**
	20,141	**(1,584)**	**18,557**	**14,591**

	Gross principal[1]	*CDS Gross protection*[2]	*Net principal exposure*[3]	*Carrying amount*[4]
2007	HK$m	HK$m	HK$m	HK$m
US	9,990	(4,296)	5,694	5,311
UK	1,934	–	1,934	1,887
Rest of the world	12,203	(2,020)	10,183	10,020
	24,127	(6,316)	17,811	17,218

1 *The gross principal is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redemption amounts through the residual life of the security.*
2 *A CDS is a credit default swap. CDS protection principal is the gross principal of the underlying instrument that is protected by CDSs.*
3 *Net principal exposure is the gross principal amount of assets that are not protected by CDSs. It includes assets that benefit from monoline protection, except where this protection is purchased with a CDS.*
4 *Carrying amount of the net principal exposure.*

b *Exposure to derivative transactions entered into with monoline insurers*

The group's principal exposure to monoline insurers is through a number of derivative transactions, primarily CDSs.

The table below sets out the mark-to-market value of the monoline derivative contracts at 31 December 2008, and hence the amount at risk, based on 31 December 2008 security prices, if the protection purchased were to be wholly ineffective because, for example, the monoline insurer was unable to meet its obligations. The 'Credit risk adjustment' column indicates the valuation adjustment taken against the mark-to-market exposures, and reflects the estimated deterioration in creditworthiness of a monoline insurer during 2008. This adjustment has been charged to the income statement.

53 Impact of market turmoil *(continued)*

	Notional amount	*Net exposure Before credit risk adjustment*[1]	*Credit risk Adjustment*[2]	*Net exposure after credit risk adjustment*
2008	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Derivative transactions with monoline insurers				
– investment grade	**1,352**	**31**	**(3)**	**28**
2007				
Derivative transactions with monoline insurers				
– investment grade	4,047	1,762	(367)	1,395

1 *Net exposure after legal netting and any other relevant credit mitigation prior to deduction of credit risk adjustment.*
2 *Fair value adjustment recorded against over-the-counter derivative counterparty exposures to reflect the credit worthiness of the counterparty.*

c *Special purpose entities (SPEs) consolidated by fellow Group companies*

The group holds commercial paper and medium-term notes issued by SPEs which have been established and are consolidated by other entities within the Group. The table below shows the group's holding of such instruments. The carrying amounts of these instruments are measured at fair value

	2008		2007	
	Gross principal	**Carrying amount**	Gross principal	Carrying amount
	HK$m	**HK$m**	HK$m	HK$m
Medium-term notes				
– AAA rated	**16,085**	**15,423**	–	–
Commercial paper				
– A1/ A1+ rated	**57,137**	**57,129**	49,987	49,855
	73,222	**72,552**	49,987	49,855

53 Impact of market turmoil *(continued)*

An analysis of the exposures underlying the group's holdings of instruments issued by entities that are consolidated by fellow Group companies is set out in the table below.

Composition of underlying asset portfolios:

	2008	2007
	HK$m	HK$m
Structured finance		
Residential mortgage-backed securities	**21,993**	14,988
Commercial mortgage-backed securities	**10,120**	4,679
Vehicle finance loan securities	**1,858**	8,594
Student loan securities	**9,225**	4,102
Other asset-backed securities	**16,069**	15,707
	59,265	48,070
Finance		
Commercial banking, investment banking and other finance company securities	**10,670**	1,785
Receivables and other	**2,617**	–
	72,552	49,855

Geographical analysis of the underlying asset portfolio:

	2008	2007
	HK$m	HK$m
US	**45,020**	18,832
UK	**12,828**	12,966
Rest of the world	**14,704**	18,057
	72,552	49,855

Exposure to sub-prime related assets included in the above:

	2008	2007
	HK$m	HK$m
Sub-prime residential mortgage related assets	**3,836**	1,489

Notes on the Financial Statements (continued)

53 Impact of market turmoil *(continued)*

d *Leveraged finance commitments by geographical segment*

Leverage finance commitments disclosed below are limited to sub-investment grade acquisition financing.

	Funded Commitments[1]	*Unfunded commitments*[2]	*Total commitments*	*Income statement write downs*
	HK$m	**HK$m**	**HK$m**	**HK$m**
2008				
Rest of Asia-Pacific	**190**	**97**	**287**	**–**
2007				
Rest of Asia-Pacific	350	2,664	3,014	–

1 *Funded commitments represent the loan amount advanced to the customer.*
2 *Unfunded commitments represent the contractually committed loan facility amount not yet drawn by the customer.*

e *Other involvement with SPEs*

The group enters into certain transactions with customers in the ordinary course of business that involve the establishment of SPEs. The purposes for which the SPEs are established include facilitating the raising of funding for customers' business activities or to effect a lease. The use of SPEs is not a significant part of the group's activities and the group is not reliant on SPEs for any material part of its business operations or profitability.

54 Ultimate holding company

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

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

55 Nature of business

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

56 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 2008 and which have not been adopted in these financial statements.

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.

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.

56 Accounting standards issued but not yet effective *(continued)*

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.

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.

A revised HKFRS 3 'Business Combinations' and an amended HKAS 27 'Consolidated and Separate Financial Statements' were issued by the HKICPA in March 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes are that:

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

The effect that the changes will have on the results and financial position of the group will depend on the incident and timing of business combinations occurring on or after 1 January 2010.

The HKICPA issued an amendment to HKFRS 2 'Share-based Payment' in March 2008. The amendment, which is applicable for annual periods beginning on or after 1 January 2009, clarifies that vesting conditions comprise only service conditions and performance conditions. It also specifies the accounting treatment for a failure to meet a non-vesting condition. The group does not expect adoption of the amendment to have a significant effect on the group's consolidated financial statements.

The HKICPA issued amendments to HKAS 32 'Financial Instruments: Presentation' and HKAS 1 'Presentation of Financial Statements' – 'Puttable Financial Instruments and Obligations Arising on Liquidation', in June 2008. The amendments are applicable for annual periods beginning on or after 1 January 2009. The group is currently assessing the effect of the amendments on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 15 'Agreements for the Construction of Real Estate' ('HK(IFRIC) – Int 15') was issued by the HKICPA in August 2008 and is effective for annual periods beginning on or after 1 January 2009. HF(IFRIC)-Int 15 provides guidance on the recognition of revenue among real estate developers for sales of units. The group does not expect adoption of HK(IFRIC)-Int 15 to have a significant effect on the group's consolidated financial statements.

Hong Kong (IFRIC) Interpretation 16 'Hedges of a Net Investment in a Foreign Operation' ('HK(IFRIC)-Int 16') was issued by the HKICPA in August 2008 and is effective for annual periods beginning on or after 1 October 2008. HK(IFRIC)-Int 16 provides guidance on accounting for the hedge of a net investment in a foreign operation in an entity's consolidated financial statements. The main change introduced by HK(IFRIC)-Int 16 is to eliminate the possibility of an entity applying hedge accounting for a hedge of foreign exchange differences between the functional currency of a foreign operation and the presentation currency of the parent's consolidated financial statements. The adoption of HK(IFRIC)-Int 16 will have no effect on the group's consolidated financial statements.

Notes on the Financial Statements (continued)

56 Accounting standards issued but not yet effective *(continued)*

The HKICPA issued 'Improvements to IFRSs' in October 2008, which comprises a collection of necessary, but not urgent amendments to HKFRSs. The amendments are primarily effective for annual periods beginning on or after 1 January 2009, with earlier application permitted. The group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

The HKICPA issued amendments to HKFRS 1 'First-time Adoption of International Financial Reporting Standards' and HKAS 27 'Consolidated and Separate Financial Statements' – 'Cost of an Investment in a subsidiary, Jointly Controlled Entity or Associate' in October 2008. The amendment is primarily effective for annual periods beginning on or after 1 January 2009. The main amendments relevant to the group are to remove the definition of the 'cost method' from HKAS 27 and require an entity to present dividends as income in the separate financial statement of the investor. The amendment to HKAS 27 will have no effect on the consolidated financial statements.

The HKICPA issued an amendment to IAS 39 'Financial Instruments: Recognition and Measurement'– 'Eligible Hedged Items' in November 2008, which is applicable for annual periods beginning on or after 1 July 2009. The amendment clarifies how the existing principles underlying hedge accounting should be applied. The group is currently assessing the effect of the amendment on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 17 'Distributions of Non-cash Assets to Owners' ('HK(IFRIC) – Int 17') was issued in December 2008 and is effective for annual periods beginning on or after 1 July 2009. HK(IFRIC) – Int 17 provides guidance on how distributions of assets other than cash as dividends to its shareholders should be accounted for. The group does not expect adoption of HK(IFRC) – Int 17 to have a significant effect on the group's consolidated financial statements.

The HKICPA issued HKFRS 1 (Revised) 'First-time Adoption of Hong Kong Financial Reporting Standards' in December 2008, which is applicable for annual periods beginning on or after 1 July 2009. The revised version has an improved structure but does not contain any technical changes. The group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 18 'Transfer of Assets from Customers' ('HK(IFRIC) – Int 18') was issued in February 2009 and is effective for annual periods beginning on or after 1 July 2009. HK(IFRIC) – Int 18 clarifies the requirements for agreements in which an entity receives from a customer an item of property, plant and equipment that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services. The group does not expect adoption of HK(IFRIC) – Int 18 to have a significant effect on the group's consolidated financial statements.

57 Events after the balance sheet date

On 1 January 2009 HSBC Bank (Vietnam) Ltd. began operations and became Vietnam's first locally-incorporated foreign bank. The majority of group's existing branch operations in Vietnam will be transferred into the newly incorporated entity.

On 2 January 2009, HSBC Malaysia Berhad was transferred to The Hongkong and Shanghai Banking Corporation Limited from another Group entity. The transfer was made at net asset value with no resulting goodwill.

58 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 2 March 2009.

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 23 to 202, which comprise the consolidated and the Bank's balance sheets as at 31 December 2008, 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 2008 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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Hong Kong

2 March 2009

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