



恒生銀行  
HANG SENG BANK

# Annual Report 2009

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## 2009年年報

The printed version of Hang Seng Bank's Annual Report 2009  
will replace this version in late March 2010.

恒生銀行2009年年報之印刷本將於2010年3月下旬取代此版本。

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## **CORPORATE PROFILE**

Established in 1933, Hang Seng Bank is the largest Hong Kong-incorporated bank and among the 50 largest listed banks in the world in terms of market capitalisation (HK\$220.6 billion as at the end of December 2009).

In Hong Kong, we serve over one-third of the population through more than 220 service outlets, including 104 branches. We also maintain a branch in Shenzhen for foreign currency wholesale business, branches in Macau and Singapore, and representative offices in Xiamen and Taipei.

Established in 2007, wholly owned mainland China subsidiary Hang Seng Bank (China) Limited operates a network of 37 outlets in Beijing, Shanghai, Guangzhou, Shenzhen, Dongguan, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin, Kunming and Foshan.

Hang Seng is a principal member of the HSBC Group, one of the world's largest banking and financial services organisations.

## RESULTS IN BRIEF

	2009	2008	Change
<b>For the year</b>	<b>HK\$m</b>	<b>HK\$m</b>	<b>%</b>
Operating profit excluding loan impairment charges and other credit risk provisions	<b>14,136</b>	16,501	-14.3
Operating profit	<b>13,324</b>	13,725	-2.9
Profit before tax	<b>15,477</b>	15,878	-2.5
Profit attributable to shareholders	<b>13,221</b>	14,099	-6.2
	<b>HK\$</b>	<b>HK\$</b>	<b>%</b>
Earnings per share	<b>6.92</b>	7.37	-6.1
Dividends per share	<b>5.20</b>	6.30	-17.5
<b>At year-end</b>	<b>HK\$m</b>	<b>HK\$m</b>	<b>%</b>
Shareholders' funds	<b>58,224</b>	51,626	12.8
Total assets	<b>825,968</b>	762,168	8.4
<b>Ratios</b>	<b>%</b>	<b>%</b>	
<i>For the year</i>			
Return on average shareholders' funds	<b>24.6</b>	26.0	
Cost efficiency ratio	<b>32.1</b>	29.2	
Average liquidity ratio	<b>48.1</b>	46.4	
<i>At year-end</i>			
Capital adequacy ratio*	<b>15.8</b>	12.5	
Core capital ratio*	<b>12.8</b>	9.5	

\* Capital ratios at 31 December 2009 were compiled in accordance with the Banking (Capital) Rules (the "Capital Rules") issued by the Hong Kong Monetary Authority ("HKMA") under section 98A of the Hong Kong Banking Ordinance for the implementation of Basel II, which came into effect on 1 January 2007. Having obtained approval from the HKMA to adopt the advanced internal ratings-based approach ("AIRB") to calculate the risk-weighted assets for credit risk from 1 January 2009, the Bank used the AIRB approach to calculate its credit risk exposure at 31 December 2009. The standardised (operational risk) approach and internal models approach were used to calculate its operational risk and market risk respectively. The capital adequacy ratio and core capital ratio at 31 December 2008 were calculated using the foundation internal ratings-based approach ("FIRB"). As there are differences between AIRB and FIRB approaches, the capital ratios of the two periods are not strictly comparable.

The basis of consolidation for calculation of capital ratios under the Capital Rules follows the basis of consolidation for financial reporting with the exclusion of subsidiaries which are "regulated financial entities" (e.g. insurance and securities companies) as defined by the Capital Rules. Accordingly, the investment costs of these unconsolidated regulated financial entities are deducted from the capital base.

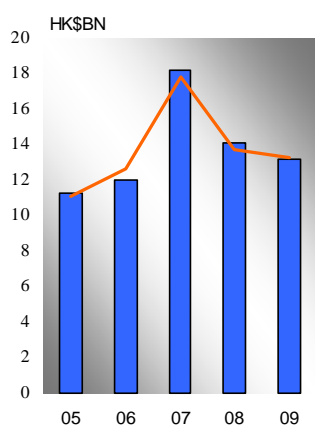
## FIVE-YEAR FINANCIAL SUMMARY

	2005	2006	2007	2008	2009
<b>For the year</b>	HK\$bn	HK\$bn	HK\$bn	HK\$bn	HK\$bn
Operating profit	11.1	12.6	17.8	13.7	<b>13.3</b>
Profit before tax	13.4	14.4	21.5	15.9	<b>15.5</b>
Profit attributable to shareholders	11.3	12.0	18.2	14.1	<b>13.2</b>
<b>At year-end</b>	HK\$bn	HK\$bn	HK\$bn	HK\$bn	HK\$bn
Shareholders' funds	42.6	47.0	56.5	51.6	<b>58.2</b>
Issued and paid up capital	9.6	9.6	9.6	9.6	<b>9.6</b>
Total assets	580.8	669.1	746.0	762.2	<b>826.0</b>
<b>Per share</b>	HK\$	HK\$	HK\$	HK\$	HK\$
Earnings per share	5.93	6.30	9.54	7.37	<b>6.92</b>
Dividends per share	5.20	5.20	6.30	6.30	<b>5.20</b>
<b>Ratios</b>	%	%	%	%	%
Post-tax return on average shareholders' funds	27.5	27.4	35.4	26.0	<b>24.6</b>
Post-tax return on average total assets	2.0	1.9	2.6	1.9	<b>1.7</b>
Capital adequacy ratio *	12.8	13.6	11.2	12.5	<b>15.8</b>
Core capital ratio *	10.4	10.7	8.4	9.5	<b>12.8</b>
Cost efficiency ratio	28.0	29.0	26.6	29.2	<b>32.1</b>

\* Capital ratios at 31 December 2009 were compiled in accordance with the Banking (Capital) Rules ("the Capital Rules") issued by the Hong Kong Monetary Authority ("HKMA") under section 98A of the Hong Kong Banking Ordinance for the implementation of Basel II, which came into effect on 1 January 2007. Having obtained approval from the HKMA to adopt the advanced internal ratings-based approach ("AIRB") to calculate the risk-weighted assets for credit risk from 1 January 2009, the Bank used the AIRB approach to calculate its credit risk exposure at 31 December 2009. The standardised (operational risk) approach and internal models approach were used to calculate its operational risk and market risk respectively. The capital adequacy ratio and core capital ratio at 31 December 2008 were calculated using the foundation internal ratings-based approach ("FIRB"). As there are differences between AIRB and FIRB approaches, the capital ratios of the two periods are not strictly comparable.

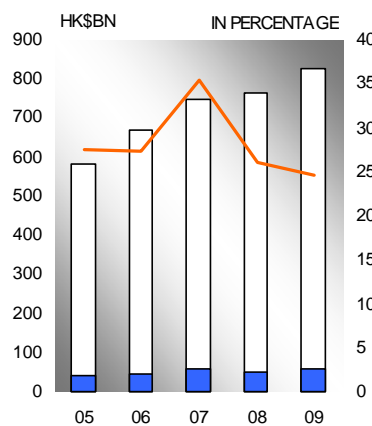
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### RESULTS



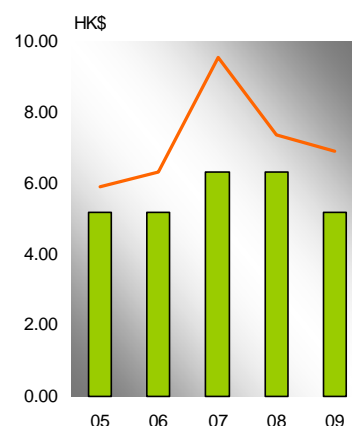
■ ATTRIBUTABLE PROFIT  
— OPERATING PROFIT

### TOTAL ASSETS AND SHAREHOLDERS' FUNDS



■ TOTAL ASSETS  
■ SHAREHOLDERS' FUNDS  
— POST-TAX RETURN ON AVERAGE SHAREHOLDERS' FUNDS

### PER SHARE EARNINGS AND DIVIDENDS



■ DIVIDENDS PER SHARE  
— EARNINGS PER SHARE

## MILESTONES

January – March	<ul style="list-style-type: none"> <li>▪ Hang Seng China launches renminbi debit cards</li> <li>▪ Gongti North Road sub-branch in Beijing opens</li> </ul>
April – June	<ul style="list-style-type: none"> <li>▪ Hang Seng opens Securities Select Customer Trading Centre</li> <li>▪ Hang Seng holds Board of Directors meeting in Yantai</li> </ul>
July – September	<ul style="list-style-type: none"> <li>▪ Two Hang Seng exchange-traded funds (ETFs) become first Hong Kong ETFs to be dual listed in Taiwan</li> <li>▪ Hang Seng launches cross-border renminbi trade settlement and clearing services</li> <li>▪ Nanshan Overseas Chinese Town sub-branch in Shenzhen opens</li> <li>▪ Hang Seng China enters into export credit insurance agreements with China Export and Credit Insurance Corporation</li> </ul>
October – December	<ul style="list-style-type: none"> <li>▪ Zhong Shan San Road sub-branch in Guangzhou opens</li> <li>▪ Hang Seng China receives permission to open its first cross-city sub-branch in Foshan under CEPA VI</li> </ul>

## AWARDS

**Best Domestic Bank in Hong Kong**

*Asiamoney*

**Best Domestic Bank in Hong Kong (for 10<sup>th</sup> consecutive year)**

*The Asset*

**Best Retail Bank in Hong Kong and Excellence in Wealth Management Awards**

*The Asian Banker*

**Asia's Best Personal Financial Services Bank**

*21<sup>st</sup> Century Business Herald*

**No. 1 for Financial Reputation and for Corporate Reputation (Hong Kong)**

*The Wall Street Journal Asia*

**SME's Best Partner Award**

*Hong Kong Chamber of Small and Medium Business*

**Best Fund (three funds managed by Hang Seng)**

*Lipper Fund Awards Hong Kong*

**Best Investor Relations Website/Webcasting (Hong Kong)**

*IR Magazine*

**Best Local Provider of Indexes in Asia (Hang Seng Indexes Company Ltd)**

*AsianInvestor*

**Excellence in Customer Experience Initiative in China Award (Hang Seng China)**

*The Asian Banker*

**Most Popular Foreign Bank and Best Wealth Management Bank Awards (Hang Seng China)**

*5<sup>th</sup> Beijing International Finance Expo*

**Most Reliable Banking Brand for Wealth Management (Hang Seng China)**

*Sohu.com*

**No. 1 for Wealth Management Products Return (Hang Seng China)**

*China Benefit*

**Best Structured Financial Product (Hang Seng China – Equity-linked Investment Product 'Daily Chance' – Auto-callable)**

*Moneyweek*

**Best Structured Financial Product (Hang Seng China – Equity-linked Partially Capital Protected Investment Product 'Easy Touch' – Auto-callable)**

*Shanghai Securities News*

## RATINGS

### Moody's Investors Service

<b>Hang Seng Bank</b>	
Long-term Bank Deposit (foreign currency)	Aa2
Long-term Bank Deposit (local currency)	Aa1
Short-term Bank Deposit (foreign currency)	Prime-1
Short-term Bank Deposit (local currency)	Prime-1
Subordinated Debt (foreign currency)	Aa2
Subordinated Debt (local currency)	Aa2
Bank Financial Strength	B+
Outlook	Positive
<b>Hang Seng Bank (China) Limited</b>	
Long-term Bank Deposit (foreign currency)	A1
Long-term Bank Deposit (local currency)	A1
Short-term Bank Deposit (foreign currency)	Prime-1
Short-term Bank Deposit (local currency)	Prime-1
Bank Financial Strength	D
Outlook	Stable

### Standard & Poor's

<b>Hang Seng Bank</b>	
Long-term Counterparty Credit (local currency)	AA
Long-term Counterparty Credit (foreign currency)	AA
Short-term Counterparty Credit (local currency)	A-1+
Short-term Counterparty Credit (foreign currency)	A-1+
Bank Fundamental Strength	B+
Outlook	Negative
<b>Hang Seng Bank (China) Limited</b>	
Long-term Counterparty Credit (local currency)	A+
Long-term Counterparty Credit (foreign currency)	A+
Short-term Counterparty Credit (local currency)	A-1
Short-term Counterparty Credit (foreign currency)	A-1
Outlook	Stable



## CHAIRMAN'S STATEMENT

The effects of the global financial crisis continued to dominate operating conditions in 2009.

In the unstable economic environment, we remained focused on our long-term growth objectives, taking steps to support both personal and commercial customers while better aligning our business for future expansion.

We promoted economic recovery through active involvement in Hong Kong Government-led lending schemes for small and medium-sized enterprises and by facilitating trade with a wide range of cross-border renminbi services.

Capitalising on our strong wealth management capabilities, we developed investment and insurance solutions that provided greater financial peace of mind in uncertain markets.

We leveraged our trusted brand and time-to-market advantage to maintain momentum in core areas of business, serve the diverse needs and interests of investors, and lay the groundwork for future development in new markets.

Our efforts have earned us the continuing loyalty of existing customers and are helping us build bridges to new ones, which will prove important business drivers as the economy returns to a firmer footing.

We remain committed to enhancing shareholder value through careful risk management and cost control while investing in our operations to promote sustainable growth over the long term.

### Financial Performance

Operating profit excluding loan impairment charges and other credit risk provisions was down 14.3 per cent at HK\$14,136 million. Operating profit declined by 2.9 per cent to HK\$13,324 million, with good credit risk management and improving economic conditions in the second half leading to a significant drop in loan impairment charges and other credit risk provisions.

Profit before tax fell by 2.5 per cent to HK\$15,477 million.

Profit attributable to shareholders was down 6.2 per cent at HK\$13,221 million. Earnings per share were HK\$6.92 – a drop of 6.1 per cent compared with a year earlier.

Lower staff-related expenses and further emphasis on cost containment resulted in a 1.8 per cent reduction in operating expenses to HK\$6,676 million. However, net operating income before loan impairment charges and other credit risk provisions was down 10.7 per cent at HK\$20,812 million, due mainly to the adverse impact of low interest rates on deposit spreads and mortgage portfolio pricing. With the reduction in operating expenses outpaced by the drop in income, our cost efficiency ratio rose to 32.1 per cent.

Return on average shareholders' funds was 24.6 per cent, compared with 26 per cent in 2008. Return on average total assets was down 0.2 percentage points at 1.7 per cent.

On 31 December 2009, our capital adequacy and core capital ratios were 15.8 per cent and 12.8 per cent respectively, as calculated using the 'advanced internal ratings-based approach' under Basel II, compared with 12.5 per cent and 9.5 per cent respectively as calculated using the 'foundation internal ratings-based approach' under Basel II at the end of 2008. The strengthening of these ratios in 2009 largely reflects profit growth after accounting for dividends during the year, the improvement in the available-for-sale debt securities reserve due to the narrowing of credit spreads, and the change in calculation methodology.

After careful consideration of our capital needs for future business opportunities, particularly in mainland China, as well as additional capital requirements under potential changes in the regulatory environment, the Directors have declared a fourth interim dividend of HK\$1.90 per share, payable on 31 March 2010. This brings the total distribution for 2009 to HK\$5.20 per share.

In the second half of last year, we appointed three new Directors to the Board. In August, Mrs Dorothy Sit, Vice-Chairman and Chief Executive of Hang Seng Bank (China) Limited, was appointed as a Non-executive Director, and Mr William Leung – formerly General Manager, Personal Financial Services and Wealth Management – was appointed as an Executive Director and Head of Personal Banking. In September, Mr Iain Mackay, Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited, was appointed as a Non-executive Director.

I would like to take this opportunity to thank our stakeholders for their continued faith in Hang Seng during a period of financial market turmoil that has affected economies, businesses and individuals across the world.

To our customers and local communities: Your loyalty and support in the challenging economic conditions have energised and inspired us in our efforts to achieve ever-higher standards of service excellence. We are proud to be a trusted partner in meeting your financial goals and wealth management needs.

To our staff: Your dedication and professionalism have been crucial in reinforcing the integrity of the Hang Seng brand, which has proved a vital source of strength in an increasingly competitive operating environment.

To our shareholders: Your strong support of Hang Seng underlines our confidence that we have a good strategy for moving our business forward and offering increasing value over the long term.

## **Outlook**

Following the implementation of unprecedented monetary and fiscal stimulus programmes by many of the world's leading economies, we are starting to see tentative signs of broad-based recovery.

Hong Kong's key economic indicators have begun to improve, with the domestic sector taking the lead. Exports registered a year-on-year increase in November 2009 after 12 consecutive months of contraction. However, the pace of expansion in many major economies will be modest at best in 2010 with external demand remaining subdued. A sustained upturn in external sector activity will be crucial in getting Hong Kong's outward-facing economy back on a solid growth track.

Supported by the Central Government's RMB4 trillion package of economic stimulus initiatives, domestic demand has driven continued growth on the Mainland – albeit at a more moderate pace than pre-crisis levels. The relatively loose monetary and fiscal policies in place during 2009 have led to surging asset prices and concerns about overheating. But with economic recovery still in its infancy, the government will likely continue to fine-tune current policies rather than make dramatic changes that may undermine growth.

Against this backdrop, we are cautiously optimistic for 2010. The global recovery will bring new and renewed business opportunities. At the same time, challenges remain. The low interest rates that are likely to persist until at least the second half of this year and keen competition in the financial sector will continue to put pressure on margins.

We will use our competitive strengths – including our widely respected brand, customer service excellence and efficient business model – to deepen relationships, reinforce our strong market position and take good advantage of new avenues of business development in support of our core income drivers.

Backed by our sound strategy and solid financial fundamentals, we will move ahead with our vision for long-term growth to the benefit of our shareholders, customers and staff.

**Raymond Ch'ien**

*Chairman*

Hong Kong, 1 March 2010

## CHIEF EXECUTIVE'S REPORT

The economic environment in 2009 created both challenges and opportunities for Hang Seng.

Despite difficult operating conditions, our long-term goals continued to guide our strategy. We made good use of our competitive strengths to serve the different financial needs of our customers, maintain momentum in core areas of business and strengthen our platform for future growth.

Competitive pressures grew during the year as banks sought to capture business flows in recovering market segments. New rules on the physical segregation of investment and banking services in Hong Kong necessitated the reorganisation of wealth management services during the second half of the year. Assisted by our strong brand, we emphasised service excellence in differentiating ourselves from our peers.

With continued financial market uncertainty in the first half of the year, we provided enhanced insurance protection offerings and defensive investment opportunities. As the outlook of investors improved during the second half, we capitalised on our time-to-market advantage to launch products in line with changing trends and tap new areas of business with good growth potential.

Leveraging our strong balance sheet and credit risk management capabilities, we assisted customers through the prudent expansion of our lending portfolios. Deposits also increased but low interest rates put significant downward pressure on spreads.

Our early actions to tackle the challenges created by the global financial crisis as well as the improving economic conditions resulted in better performances by our core business drivers in the second half of 2009 compared with the first half.

We further enhanced our service delivery channels – particularly our online and mobile phone platforms – to provide greater choice over when and where customers manage their finances. The number of Personal e-Banking and Business e-Banking customers grew by 12.8 per cent and 19 per cent respectively.

Our mainland China subsidiary bank, Hang Seng Bank (China) Limited, extended its service reach by adding outlets and building new business alliances. Close collaboration between colleagues on the Mainland and in Hong Kong led to new wealth management products and the strengthening of cross-border capabilities – supporting good growth in the Mainland customer base.

### Customer Group Highlights

Personal Financial Services recorded an 11.9 per cent drop in operating profit excluding loan impairment charges to HK\$7,457 million and a 13.7 per cent fall in profit before tax to HK\$7,258 million.

Operating profit excluding loan impairment charges and profit before tax for the second half of 2009 were up 8.4 per cent and 9.3 per cent respectively compared with the first half.

Although advances to individuals increased, interest margins on deposits and the mortgage portfolio fell, resulting in a 5.8 per cent reduction in net interest income.

Despite subdued investor sentiment, we maintained wealth management business flows, recording a 2.4 per cent decline in income. Revenue from wealth management in the second half of 2009 increased by 14.7 per cent compared with the first half.

With continuing economic uncertainty, particularly in the first half of the year, we provided life insurance protection and investment solutions that emphasised financial security.

As market conditions began to stabilise, we used our Securities Select Customer Trading Centre and attractive IPO investment services to capitalise on renewed interest in securities trading, promoted lower-risk yield-enhancement investment products and launched new Hang Seng-branded investment funds that received a good response from customers. These actions helped drive a 36.8 per cent rise in investment income in the second half of the year compared with the first half, with increases across all major revenue streams.

In August, we became the first Hong Kong financial institution to achieve a dual listing of exchange-traded funds (ETFs) in Taiwan.

Overall, investment income dropped by 23.2 per cent for 2009. The growth in revenue from stockbroking and related services was outweighed by declines in income from investment funds and structured investment products. Private Banking service fee income also fell, reflecting the reduced level of investment activity.

Life insurance income rose by 46.8 per cent, due mainly to our proactive management of the life insurance funds investment portfolio – which resulted in a HK\$17 million investment gain in 2009 compared with a HK\$1,063 million loss in 2008 – as well as the increase in net interest income arising from the growth in the portfolio and asset reallocation.

Commercial Banking's profit before tax was up 6.8 per cent at HK\$2,637 million. Operating profit excluding loan impairment charges fell by 15.5 per cent, due mainly to the 16.6 per cent drop in net interest income. Operating profit increased by 14 per cent, with good management of credit risk and improvements in the economic environment underpinning a 67.4 per cent reduction in loan impairment charges.

Operating profit excluding loan impairment charges and profit before tax for the second half of 2009 rose by 9.1 per cent and 44.2 per cent respectively compared with the first half.

Strong customer relationships, active participation in Hong Kong Government-led small and medium-sized enterprise loan schemes, and enhanced service capabilities drove good increases in both customer advances and deposits – which rose by 12.1 per cent and 26 per cent respectively. Net interest income from lending was up 15.4 per cent, but the low interest rate environment saw net interest income from deposits drop by 47.7 per cent.

Success with new corporate life insurance products helped sustain corporate wealth management income – which fell by just 1.8 per cent despite the less favourable environment for investment business.

Corporate Banking achieved a 20.1 per cent increase in operating profit excluding loan impairment charges to HK\$979 million. A significant improvement in loan impairment charges saw operating profit grow by 46.7 per cent to HK\$901 million. Profit before tax was HK\$915 million – an increase of 41.9 per cent.

Total operating income grew by 15.4 per cent, supported mainly by the 17.2 per cent rise in net interest income. We capitalised on our balance sheet strength and good understanding of local markets to assist corporate customers with new and renewed facilities while adjusting pricing in line with the credit environment, resulting in a 41.5 per cent increase in net interest income from advances. Net interest income from deposits fell by 36.4 per cent.

Treasury's operating profit excluding credit risk provisions declined by 3.9 per cent to HK\$2,918 million.

We continued with our prudent risk management strategy, working to enhance the portfolio mix through investment in high-quality debt securities and selectively disposing of negotiable instruments as market conditions changed.

Net interest income fell by 19.4 per cent, with low interest rates keeping the cost of funds down but limiting yields on new deployments of funds and balance sheet management portfolio investments. Net trading income grew by 64.4 per cent. With weak investor demand for equity and interest rate-linked products, we successfully maintained momentum in Treasury's customer-driven business by enhancing the features of our foreign exchange-linked investment offerings.

Treasury's profit before tax increased by 48.9 per cent, due mainly to a HK\$1,375 million credit risk provision booked in 2008.

## **Mainland Business**

Including a sub-branch opened in January 2010 under CEPA VI, Hang Seng China now operates 37 outlets across 12 cities.

Hang Seng China's profit before tax achieved steady growth, reflecting an increase in total operating income as well as reductions in both operating expenses and loan impairment charges.

Hang Seng China's operating income grew by 3.9 per cent, underpinned by a 1.3 per cent rise in net interest income. Further expansion of our cross-border Commercial Banking capabilities and range of wealth management products drove an 18.3 per cent year-on-year increase in the Mainland customer base and a 35.9 per cent rise in deposits. Advances to customers rose by 5.2 per cent as we continued to focus on the quality rather than the size of the loans portfolio. With deposits growth significantly outpacing the expansion in lending, balance sheet strength improved.

Collaborative initiatives with strategic partners Industrial Bank and Yantai Bank provided synergy in key areas of business and extended our reach in regions with strong economic growth potential.

Including the share of profits from Mainland associates, our Mainland business contributed 13.3 per cent to total profit before tax, compared with 11.9 per cent a year earlier.

## **Financial Highlights**

Total assets increased by HK\$63.8 billion, or 8.4 per cent, to HK\$826 billion. Surplus funds from maturing trading assets were redeployed to interbank placements and high-quality available-for-sale debt securities, resulting in a 33.3 per cent rise in financial investments. Advances to customers grew by 4.7 per cent. Customer deposits increased by 9.8 per cent, reflecting a marked preference for liquidity in the uncertain economic environment.

Despite a 7.1 per cent rise in average interest-earning assets, net interest income fell by 13.6 per cent to HK\$14,023 million. Increased contributions from our lending business and investments under the life insurance funds investment portfolio were more than offset by the adverse impact of low interest rates on contributions from deposits and net free funds. Net interest margin was down 0.46 percentage points at 1.90 per cent.

Net fee income dropped by 13 per cent to HK\$4,321 million, due mainly to reduced fee income from structured investment products issued by third parties, investment funds and private banking, which fell by 91.8 per cent, 44.3 per cent and 44.9 per cent respectively. Card services fee income rose by 8.4 per cent on the back of good increases in the card base, spending and receivables. Insurance-related fee income grew by 93.9 per cent. Fee income from stockbroking and related services increased by 15.2 per cent due to the recovery in the stock market and our market positioning. Effective actions to capitalise on improving investor sentiment and continuing growth in our credit cards business helped support a 24.4 per cent rise in fee income in the second half of the year compared with the first half.

Trading income rose by 32.2 per cent to HK\$1,923 million. Foreign exchange income grew by 29.5 per cent, due mainly to the increase in net interest income from funding swaps and reduced losses on the revaluation of Hang Seng China's US dollar capital funds against the renminbi.

Lower employee-related expenses and good cost control led to reductions in operating expenses in both Hong Kong and the Mainland to record a total decline of 1.8 per cent. However, with net operating income before loan impairment charges and other credit risk provisions down 10.7 per cent at HK\$20,812 million, our cost efficiency ratio rose to 32.1 per cent – up 2.9 percentage points compared with 2008.

With greater stability in the economic environment and effective actions to enhance the quality of the lending and investment portfolios, loan impairment charges and other credit risk provisions fell by HK\$1,964 million, or 70.7 per cent, to HK\$812 million.

At 31 December 2009, total loan impairment allowances as a percentage of gross advances to customers was 0.56 per cent and gross impaired advances as a percentage of gross advances to customers was 0.7 per cent – improvements of 5 and 30 basis points respectively compared with the

end of 2008. Impairment charges as a percentage of average advances to customers improved by 18 basis points to 0.25 per cent.

## **Moving Ahead**

In a year marked by economic uncertainty, Hang Seng remained committed to a forward-looking strategy that focuses on the long term. We have continued to support customers, sustain the momentum of growth drivers and establish new avenues of revenue generation.

Investors are placing greater emphasis on personalised financial services and the timely provision of information. Businesses facing difficult operating conditions are demanding one-stop financial assistance with fast and efficient delivery channels that can give them an edge over their competitors. Good anticipation of customer needs in rapidly changing markets is a vital tool in achieving and maintaining leadership. Financial institutions that fail to think ahead will be left behind.

Hang Seng's strengths – including service excellence, time-to-market capabilities and a strong distribution network – will continue to serve us well, helping us deepen existing customer relationships and acquire new ones.

Our diverse portfolio of investment and insurance products enables us to provide tailored wealth management solutions for a wide range of market conditions and financial needs. Our wealth management business – particularly sales of investment funds – has gained strong momentum during the first two months of 2010 and we will build on this with new products and services.

With deep roots in our communities, our local knowledge allows us to identify emerging trends ahead of the curve to the mutual benefit of our customers and our business. Following on from our ground-breaking dual listing of ETFs in Taiwan last year, we will take more steps to develop new revenue streams that support our core business lines.

Commercial Banking's growing range of cross-border services and corporate wealth management offerings will help us strengthen ties with commercial customers and attract new business. We will further enhance cross-selling and leverage our multi-channel platforms and payment and cash management capabilities in Hong Kong and on the Mainland as part of our new customer acquisition strategy.

Our support of Corporate Banking clients in challenging economic times puts us in a good position to deepen these partnerships as market conditions improve.

We will take advantage of opportunities to expand our renminbi services for commercial and corporate customers in Hong Kong following new measures announced by the Hong Kong Monetary Authority last month that widen the scope of renminbi business.

Treasury will continue to prudently manage its investment portfolio to strike a good balance between risk and return. We will further enhance Treasury's service infrastructure and product development capabilities to strengthen fee-earning potential.

We will upgrade and expand our service delivery channels to provide customers with greater efficiency and convenience in managing their financial needs. We will maintain a high level of vigilance in the management of our loans portfolios and other credit risks.

Hang Seng China will further grow its brand on the Mainland, make good use of its strategic alliances and extend its business reach in high-potential locations – including Guangdong under the favourable policies of CEPA VI.

Supported by Hang Seng's strong capabilities in Hong Kong, we will expand our wealth management offerings on the Mainland to attract more customers in target segments. We will promote our comprehensive cross-border services to increase the Mainland commercial customer base. These initiatives will help drive deposits growth, providing important support for business expansion.

On top of our investments in Industrial Bank and Yantai Bank, we are actively looking for strategic partners in wealth management industries on the Mainland.

We will continue to invest in staff capabilities, technology and initiatives that enhance our reputation as a leading provider of Greater China financial expertise.

The past year has been a challenging one but we are looking ahead – to identify new opportunities and ensure our strategic decisions best serve our long-term goals.

Supported by our trusted brand and solid financial fundamentals, we will reinforce our leadership in traditional lines, build momentum in areas with good potential for further business expansion, and explore new markets and customer segments in order to deliver sustainable growth.

**Margaret Leung**

*Vice-Chairman and Chief Executive*

Hong Kong, 1 March 2010

## **CORPORATE RESPONSIBILITY**

Hang Seng has a strong tradition of contributing to the development of society. Simply stated, we believe in the importance of service and putting people – customers, staff, shareholders and the wider community – at the heart of everything we do. This attitude has shaped our approach to business since our establishment in 1933.

Our corporate citizenship programmes have seen us recognised as a Caring Company by the Hong Kong Council of Social Service every year since 2003. In 2001, we became a constituent stock of the FTSE4Good Global Index, which tracks the performance of companies that meet international standards of corporate responsibility. A 2009 survey conducted by Oracle Added-Value among customers of eight major banks in Hong Kong ranked Hang Seng joint first for corporate citizenship.

Our annual online corporate responsibility report, available on our website, provides detail on our principles and actions as a good corporate citizen and our relationships with stakeholders. The report also serves as an important benchmark for assessing our social and environmental performance.

### **A Community-focused Bank**

In the past 10 years, we have provided over HK\$211 million in donations and support – including more than HK\$29 million in 2009 – for social and environmental initiatives.

This commitment to giving is reflected at all levels of our organisation. Members of our senior management donate their time to take up positions with charities and public bodies. Our staff and their families logged over 17,000 hours in volunteer service in 2009 – 50 per cent more than in 2008.

We place emphasis on supporting events that promote social cohesion and inclusion. Our volunteers participated in home visits, day trips and special events for the elderly and underprivileged children in 2009. We worked with the Regeneration Society to celebrate the achievements of individuals who have overcome significant physical challenges to highlight the importance of positive life values. To help bring cheer to chronically ill children, nearly 100 members of Bank staff and their families helped paint eight murals at the Children's Centre for Cancer and Blood Diseases at Queen Mary Hospital.

Through staff participation in the Dress Special Day, we raised over HK\$1.2 million for The Community Chest of Hong Kong, with the Bank matching staff donations on a dollar-for-dollar basis. Since 1997, we have donated more than HK\$12 million to The Chest through this annual fundraising event.

We also work to facilitate charitable giving by our customers. Since 2001, donations of more than HK\$16 million – including HK\$1.55 million in 2009 – have been made to a variety of worthy causes through our e-Donation service.

### ***Investing In Our Future***

Today's young people are tomorrow's leaders, making youth development a crucial element of our corporate responsibility efforts. We supported 35 programmes focusing on young people in 2009, allocating about HK\$6.5 million to nurturing talent and building positive life attitudes.

Since 1995, we have provided more than HK\$54 million under various scholarship schemes, enabling over 1,500 students from Hong Kong and mainland China to pursue educational excellence at tertiary institutions, including 188 individuals in 2009.

Our support of initiatives such as the Ming Pao Student Reporter Programme and the 'Protect Yourself from Crime and Predators Online' video competition organised by the Hong Kong Police Force help young people develop their creative and communications skills while gaining a greater awareness of current affairs and social issues.

Run in partnership with the Hong Kong Federation of Youth Groups, the Hang Seng Bank Leaders to Leaders Lecture Series provided over 300 secondary school students with opportunities to engage in direct dialogue with prominent community leaders on a wide range of topics related to China's development and position in the world.



We worked with The Pathways Foundation to help children with specific learning disabilities and attention deficit / hyperactivity disorder to explore their potential and different ways of learning through a series of after-school programmes and workshops for parents.

Our sponsorship of student ticket schemes for the Hong Kong Arts Festival and the Hong Kong Philharmonic Orchestra – which enabled more than 20,000 students to attend performances at half price – are making arts more accessible for young people.

### ***Playing To Win***

Under the Hang Seng Athlete Incentive Awards Scheme, we were proud to recognise and reward the outstanding achievements of Hong Kong's athletes at the 11<sup>th</sup> National Games in Shandong and the 5<sup>th</sup> East Asian Games held in our home city. In partnership with the Hong Kong Sports Institute (HKSI), we awarded 203 Hong Kong medallists about HK\$7.2 million. These outstanding sportsmen and sportswomen not only bring honour to Hong Kong, but also provide lessons about the importance of commitment, determination and teamwork, and act as inspirational role models for future generations of athletes at all levels of ability. Since 1996, Hang Seng and the HKSI have distributed over HK\$15 million in incentives to 280 exceptional Hong Kong athletes.

The Hang Seng Table Tennis Academy organised more than 350 activities in 2009 – including training courses, assessment tests and championships – that helped over 18,000 individuals hone their table tennis skills. With support from Bank volunteers, we held two table tennis fun days for underprivileged children at the Bank's Penthouse with the aim of using sport as a way to build self-esteem. In the past 14 years, we have spent more than HK\$25 million to develop table tennis in Hong Kong.

To promote staff health and the importance of a good work-life balance, we operate a gym at our MegaBox premises and encourage our employees to participate in a wide range of sporting and recreational activities.

### **A Green Bank**

Our concern for the environment begins with our own operations and extends into our relationships with customers, business partners and the wider community. As part of our commitment to continual improvement, we take steps to minimise the ecological footprint of our business, engage in activities that have a positive impact on the environment, and encourage responsible behaviour through our investment and financing policies.

We established an Environmental Management Committee in 2003, which implements and monitors our environmental management system. In 2005, we became the first local financial institution in Hong Kong to achieve ISO 14001 certification – gained for our headquarters building. We achieved accreditation for our Hang Seng Tower and MegaBox offices in 2006 and 2008 respectively, and, in 2009, our network of 25 branches on Hong Kong Island received certification. We have been carbon neutral since 2007.

In 2009, we reduced our greenhouse gas emissions per full-time equivalent employee by 4.6 per cent.

By replacing the air-cooled chillers of the air-conditioning system at our headquarters building with water-cooled chillers, we cut our annual electricity consumption by about 1.9 million kWh and annual carbon dioxide emissions by over 1,700 tons. Modifications to the lighting systems in our ATMs reduced their electricity consumption by around 330,000 kWh per year – an energy saving of 33 per cent.

We recycled more than 7,300 pieces of obsolete computer equipment, weighing over 85 tons, and about 14,000 toner and printer ink cartridges.

We continue to work with the business community on environmental issues through the Hang Seng Bank Pearl River Delta Environmental Awards. Run in partnership with the Federation of Hong Kong Industries, the Awards encourage and reward sound environmental practices by manufacturing companies in Hong Kong and the Pearl River Delta. More than 120 companies engaged in over 400 environmental projects took part in the 2008/09 Awards, representing significant reductions in air

emissions, waste generation, water use and electricity consumption.

We employ technology to help save resources by promoting the use of electronic transaction and communication channels. More than 334,000 e-Banking customers now use our e-Statement service under which they receive their account statements in PDF rather than paper format. Over 62,000 customers have made a similar switch for investment advice under our e-InvestAdvice service. These electronic initiatives are saving over 18 million sheets of paper a year.

Our efforts to raise the environmental awareness of our staff also benefit local communities. Working with The Conservancy Association, we facilitated the construction of another 300 biogas toilets in Yunnan province with sponsorship and the active participation of Bank volunteers who travelled to rural areas to assist with the project. To date, we have supported the construction of 500 biogas toilets that save a total of 1,250 tons of firewood and reduce carbon dioxide emissions by 6,250 tons per year. In Hong Kong, staff volunteers have helped clean up beaches, supported reforestation efforts at country parks, and attended talks and lectures that promote positive environmental messages.

Environmental considerations form part of our lending and financing policies and we incorporate environmental risk assessments into our credit decisions. We have specific guidelines for lending to companies in environmentally sensitive sectors such as forestry, the chemical industry and freshwater infrastructure.

We work to help conserve biodiversity by complying with the sustainability guidelines set out in WWF Hong Kong's *Seafood Guide*. In 2003, we stopped serving shark's fin at Hang Seng functions and have since extended this policy to include endangered reef fish species and black moss.

In dealing with suppliers, we make use of e-procurement and e-auction systems that help cut down on printed materials and lead times. New suppliers are required to go through an appraisal exercise that covers issues such as environmental performance and health and safety practices.

We support the Equator Principles and the Copenhagen Communique on Climate Change. We participate in the international Carbon Disclosure Project and in various environmental initiatives and campaigns organised by green groups including Friends of the Earth (HK) and WWF Hong Kong.

## Environmental Performance

	2009	2008	2007	2006	2005	2009 vs 2008 (%)	2009 vs 2007 (%)
Greenhouse gas emissions per person* (tons CO <sub>2</sub> /FTE)	3.13	3.28	3.30	3.30	3.61	-4.57	-5.15
Greenhouse gas emissions per m <sup>2</sup> * (tons CO <sub>2</sub> /m <sup>2</sup> )	0.17	0.20	0.20	0.20	0.21	-15.00	-15.00
Greenhouse gas emissions* (kilotons CO <sub>2</sub> )	24.52	27.40	26.70	25.30	26.40	-10.51	-8.16
Electricity consumption (GWh)	36.50	38.10	35.90	34.10	33.30	-4.20	1.67
Gas consumption (GWh)	0.40	0.42	0.70	0.82	0.86	-4.76	-42.86
Water consumption (000 m <sup>3</sup> )	55.85	50.80	54.10	70.40	91.10	9.94	3.23
IT/electrical waste recycled (tons)	85.03	64.90	59.00	41.70	38.80	31.02	44.12

Data coverage: Hang Seng Bank's Hong Kong operations

Key:

FTE: Full-time equivalent

m<sup>2</sup>: Square metres

m<sup>3</sup>: Cubic metres

CO<sub>2</sub>: Carbon dioxide

GWh: Gigawatt hours

\*Hang Seng Bank's Hong Kong operations have been carbon neutral since 2007

## **CORPORATE GOVERNANCE AND OTHER INFORMATION**

Hang Seng is committed to high standards of corporate governance with a view to safeguarding the interests of shareholders, customers, staff and other stakeholders. The Bank has followed the module on “Corporate Governance of Locally Incorporated Authorised Institutions” under the Supervisory Policy Manual issued by the Hong Kong Monetary Authority (“HKMA”) and has fully complied with all the code provisions and most of the recommended best practices as set out in the Code on Corporate Governance Practices contained in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the “Listing Rules”) throughout the year. The Bank also keeps its corporate governance framework under constant review to ensure that it is in line with international and local best practices.

### **BOARD OF DIRECTORS**

#### **The Board**

The Board has collective responsibility for leadership and control of, and for promoting the success of, the Bank by directing and supervising the Bank's affairs.

The types of decisions which are to be taken by the Board include those relating to :

- five-year strategic plan;
- annual operating plans and performance targets;
- annual and interim results;
- specified senior appointments;
- acquisitions and disposals above predetermined thresholds; and
- substantial changes to balance sheet management policies.

#### **Chairman and Chief Executive**

The roles of Chairman of the Board and Chief Executive of the Bank are segregated, with a clear division of responsibilities. The Chairman of the Board is an Independent Non-executive Director who is responsible for the leadership and effective running of the Board. The Chief Executive is an Executive Director who exercises all the powers, authorities and discretions of the Executive Committee as may be delegated to her in respect of the Bank and its subsidiaries.

#### **Board Composition**

As at the date of this Annual Report, the Board comprises 13 Directors, of whom two are Executive Directors and 11 are Non-executive Directors. Of the 11 Non-executive Directors, six are Independent Non-executive Directors. There is a strong independent element on the Board, to ensure the independence and objectivity of the Board's decision-making process as well as the thoroughness and impartiality of the Board's oversight of the Management.

All the Independent Non-executive Directors meet the guidelines for assessment of independence as set out in Rule 3.13 of the Listing Rules. The Bank has also received from each of the Independent Non-executive Directors an annual confirmation of his independence.

Members of the Board, who come from a variety of different backgrounds, have a diverse range of business, banking and professional expertise. Brief biographical particulars of all the Directors, together with information relating to the relationship among them, are set out in the section “Biographical Details of Directors” in this Annual Report.

## **Board Process**

Regular Board/Committee meeting schedules for each year are made available to all Directors/Committee members before the end of the preceding year. In addition, notice of meetings will be given to all Directors prior to each Board meeting, at least 14 days in advance.

Other than regular Board meetings, in 2009, the Chairman also met with Non-executive Directors, including Independent Non-executive Directors, without the presence of Executive Directors, to facilitate an open and frank discussion among the Non-executive Directors on issues relating to the Bank.

Meeting agenda for regular Board meetings are set after consultation with the Chairman and the Chief Executive. All Directors are given an opportunity to include matters in the agenda.

The Board reviews and evaluates its work process and effectiveness annually, with a view to identifying areas for improvement and further enhancement.

All Directors have access to the Company Secretary who is responsible for ensuring that the Board procedures, and related rules and regulations, are followed.

Under the Articles of Association of the Bank, a Director generally shall not vote or be counted in the quorum in respect of any contract, arrangement, transaction or other proposal in which he/she or his/her associate(s), is/are materially interested.

Minutes of Board/Committee meetings are kept by the Company Secretary and are open for inspection by Directors.

## **Appointments, Re-election and Removal**

The Bank's Articles of Association provide that each Director is required to retire by rotation once every three years and that one-third (or the number nearest to one-third) of the Directors shall retire from office every year at the Bank's Annual General Meeting. A Director's specific term of appointment, therefore, cannot exceed three years. Retiring Directors are eligible for re-election at Annual General Meetings of the Bank.

The Bank uses a formal, considered and transparent procedure for the appointment of new Directors. Before a prospective Director's name is formally proposed, opinions of the existing Directors (including the Independent Non-executive Directors) will be solicited. The appointment will be considered and if thought fit, approved by the Board after due deliberation. In accordance with the requirement under the Banking Ordinance, approval from HKMA will also be obtained. All new Directors are subject to election by shareholders of the Bank at the next Annual General Meeting after their appointments have become effective.

Four new Directors were appointed in 2009, namely, Mrs Margaret Leung Ko May Yee, Mrs Dorothy Sit Kwan Yin Ping, Mr William Leung Wing Cheung and Mr Iain James Mackay. Mrs Margaret Leung's appointment was approved by the Board at its meeting held on 24 February 2009 and she was elected by the Bank's shareholders at its Annual General Meeting held on 6 May 2009. The appointments of the other three new directors were approved by the Board at its meeting held on 28 July 2009 and will be put forward to the Bank's shareholders for election at its Annual General Meeting to be held on 14 May 2010.

## **Responsibilities of Directors**

The Bank regularly reminds all Directors of their role and responsibilities. Through regular Board meetings, all Directors are kept abreast of the conduct, business activities and development of the Bank.

Induction programmes are arranged for newly appointed Directors. All Directors are given opportunities to update and develop their skills and knowledge.

All Directors have full and timely access to all relevant information about the Bank so that they can discharge their duties and responsibilities as Directors. There are established procedures for Directors to seek independent professional advice on matters relating to the Bank where appropriate. All costs associated with obtaining such advice will be borne by the Bank. In addition, each Director has separate and independent access to the Bank's senior management.

The Bank has adopted a Code for Securities Transactions by Directors on terms no less exacting than the required standards as set out in the Model Code for Securities Transactions by Directors of Listed Issuers (as set out in Appendix 10 to the Listing Rules). Specific enquiries have been made with all Directors who have confirmed that they have complied with the Bank's Code for Securities Transactions by Directors throughout the year.

Appropriate Directors' liability insurance cover has also been arranged to indemnify the Directors for liabilities arising out of corporate activities. The coverage and the sum insured under the policy are reviewed annually.

The interests in Group securities, including securities relating to HSBC Holdings plc and the Bank, held by the Directors as at 31 December 2009 are disclosed in the Directors' Report as set out in this Annual Report.

## Board Members' Attendance

Name	Number of meetings attended during 2009
Dr Raymond K F Ch'ien* ( <i>Chairman</i> )	7 out of 7
Mrs Margaret Leung ( <i>Vice-Chairman and Chief Executive</i> ) ( <i>Appointed as Non-executive Director with effect from 1 April 2009 and as Vice-Chairman and Chief Executive with effect from 6 May 2009</i> )	4 out of 5
Mr Raymond C F Or ( <i>Former Vice-Chairman and Chief Executive</i> ) ( <i>Retired from the Board with effect from 6 May 2009</i> )	3 out of 3
Mr Edgar D Ancona <sup>#</sup> ( <i>Resigned as Director with effect from 1 September 2009</i> )	5 out of 5
Dr John C C Chan*	7 out of 7
Mr Patrick K W Chan ( <i>Former Executive Director and Chief Financial Officer</i> ) ( <i>Retired from the Board with effect from 6 May 2009</i> )	2 out of 3
Dr Y T Cheng* ( <i>Resigned as Director with effect from 6 May 2009</i> )	2 out of 3
Dr Marvin K T Cheung*	4 out of 7
Mr Alexander A Flockhart <sup>#</sup>	6 out of 7
Mr Jenkin Hui*	6 out of 7
Mr Peter T C Lee* ( <i>Passed away on 17 October 2009</i> )	5 out of 6
Mr William W Leung ( <i>Appointed as Executive Director with effect from 7 August 2009</i> )	2 out of 2
Dr Eric K C Li*	7 out of 7
Dr Vincent H S Lo <sup>#</sup>	6 out of 7
Mr Iain J Mackay <sup>#</sup> ( <i>Appointed as Non-executive Director with effect from 1 September 2009</i> )	2 out of 2
Mr Joseph C Y Poon ( <i>Former Managing Director and Deputy Chief Executive</i> ) ( <i>Resigned from the Board with effect from 30 September 2009</i> )	6 out of 6
Dr David W K Sin* ( <i>Resigned as Director with effect from 6 May 2009</i> )	2 out of 3
Mrs Dorothy K Y P Sit <sup>#</sup> ( <i>Appointed as Non-executive Director with effect from 7 August 2009</i> )	2 out of 2
Mr Richard Y S Tang*	7 out of 7
Mr Peter T S Wong <sup>#</sup>	6 out of 7

\* Independent Non-executive Directors

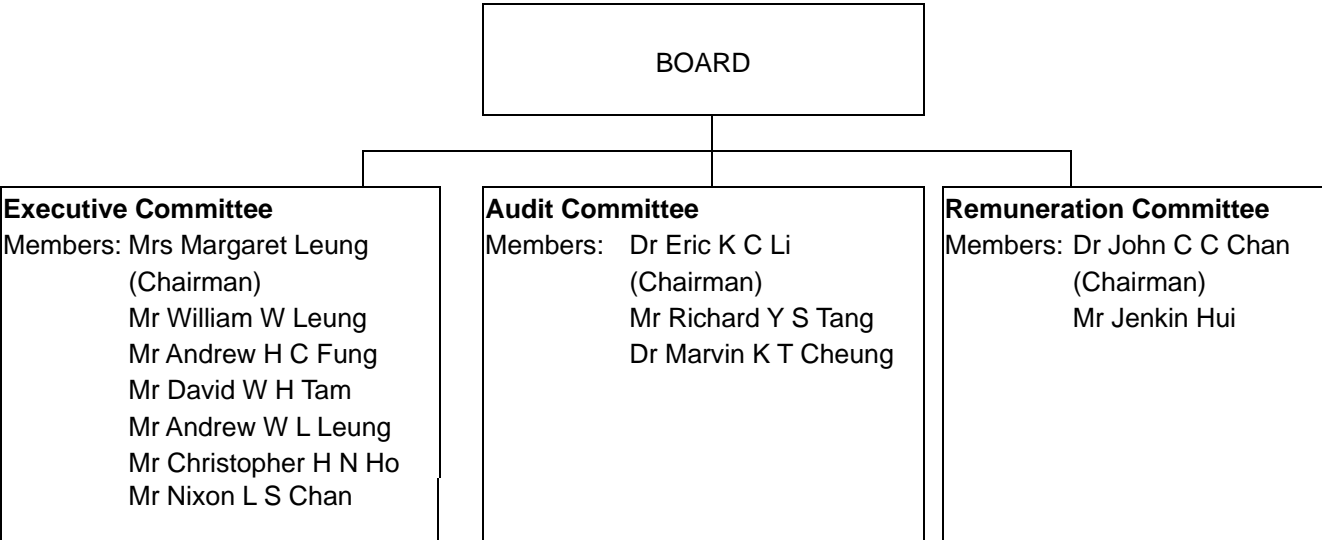
<sup>#</sup> Non-executive Directors

# DELEGATION BY THE BOARD

## Board Committees

The Board has set up three committees, namely, the Executive Committee, the Audit Committee and the Remuneration Committee, to assist it in carrying out its responsibilities.

Each of these committees has specific written terms of reference which set out in detail their respective authorities and responsibilities. All committees, except the Executive Committee, are comprised solely of Independent Non-executive Directors. All committees report back to the Board on their decisions or recommendations on a regular basis.



The **Executive Committee** meets at least once each month and operates as a general management committee under the direct authority of the Board. It exercises the powers, authorities and discretions as delegated by the Board in so far as they concern the management and day-to-day running of the Bank in accordance with its terms of reference and such other policies and directives as the Board may determine from time to time. The Executive Committee also sub-delegates credit, investment and capital expenditure authorities to its members and senior executives.

To further enhance the Bank’s risk management framework and in line with best practices, the Bank has set up a Risk Management Committee to centralise the risk management oversight function of the Bank. The Risk Management Committee reports directly to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank, including all the eight types of risks stipulated in the Supervisory Policy Manual of HKMA, namely, credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal and compliance risk, reputation risk and strategic risk. In addition, the Risk Management Committee also covers insurance risk, pension risk and sustainability risk, and is responsible for approval of all risk management related policies.

The **Audit Committee** meets regularly, normally at least four times a year, with the Bank’s senior executives from financial control, internal audit and compliance, and the external auditors, to consider, among other things, the Bank’s financial reporting, the nature and scope of audit reviews and the effectiveness of the systems of internal control and compliance. It is also responsible for the appointment, reappointment, removal and remuneration of the Bank’s external auditors. The Audit Committee reports to the Board following each Audit Committee meeting, drawing the Board’s attention to salient points that the Board should be aware of, identifying any matters in respect of which it considers that action or improvement is needed and making relevant recommendations.

The **Remuneration Committee** considers human resources issues and makes recommendations to the Board on the Bank’s policy and structure for remuneration of Directors and senior management. It meets at least twice a year.

## Committee Members' Attendance

Name	Number of meetings attended during 2009		
	Executive Committee	Audit Committee	Remuneration Committee
Mrs Margaret Leung	8 out of 8	-	-
Mr Raymond C F Or (Ceased to be a member with effect from 6 May 2009)	4 out of 4	-	-
Dr John C C Chan*	-	-	3 out of 3
Mr Patrick K W Chan (Ceased to be a member with effect from 8 July 2009)	5 out of 6	-	-
Dr Marvin K T Cheung*	-	5 out of 5	-
Mr Jenkin Hui*	-	-	3 out of 3
Mr Peter T C Lee* (Passed away on 17 October 2009)	-	-	2 out of 2
Mr William W Leung	12 out of 12	-	-
Dr Eric K C Li*	-	5 out of 5	-
Mr Joseph C Y Poon (Ceased to be a member with effect from 30 September 2009)	8 out of 9	-	-
Mrs Dorothy K Y P Sit (Ceased to be a member with effect from 7 August 2009)	7 out of 7	-	-
Mr Richard Y S Tang*	-	5 out of 5	-
Mr Andrew H C Fung	12 out of 12	-	-
Mr David W H Tam (Note)	3 out of 3	-	-
Mr Andrew W L Leung (Note)	3 out of 3	-	-
Mr Christopher H N Ho (Note)	2 out of 3	-	-
Mr Nixon L S Chan (Note)	3 out of 3	-	-

\* Independent Non-executive Directors

(Note: Mr David W H Tam (Chief Risk Officer), Mr Andrew W L Leung (Chief Financial Officer), Mr Christopher H N Ho (Chief Technology and Services Officer) and Mr Nixon L S Chan (Head of Corporate and Commercial Banking) were appointed members of the Executive Committee in October 2009.)

## REMUNERATION OF DIRECTORS AND SENIOR MANAGEMENT

### The Level and Make-up of Remuneration

The Remuneration Committee is responsible for setting up the policy on remuneration of Directors and senior management.

The Remuneration Committee held three meetings in 2009. The major work performed by the Committee during 2009 included:

- reviewing the fees payable to the Directors and the Committee Chairmen/Members of the Board Committees of the Bank and its subsidiaries;
- reviewing the remuneration of the Executive Directors and senior management of the Bank;
- reviewing the proposed bonus pool under the Variable Incentive Scheme of the Bank;
- determining the remuneration packages of newly appointed senior executives of the Bank;
- reviewing the pay review proposal of the Bank; and
- reviewing HKMA's consultation paper on the draft "Guideline on a Sound Remuneration System".

The Bank's policy on remuneration is to maintain fair and competitive packages based on business needs and industry practice. For determining the level of fees paid to the Directors, market rates and factors such as each Director's workload and required commitment will be taken into account. The following factors are considered when determining the remuneration packages of Executive Directors:

- business needs;
- general economic situation and market sentiment following the financial crisis in late 2008;
- changes in appropriate markets such as supply/demand fluctuations and changes in competitive conditions;
- individual contributions to results as confirmed in the performance appraisal process; and
- retention consideration and individual potential.

No individual Director will be involved in decisions relating to his/her own remuneration.

The present scales of Director's fees, and additional fees for Chairmen and members of the Audit Committee and Remuneration Committee, are outlined below:

	Amount
Board of Directors: Director's annual fees	
Chairman	HK\$360,000
Vice-Chairman	Nil *
Other Directors	HK\$280,000 *
Audit Committee: Additional annual fees	
Chairman	HK\$120,000
Other Members	HK\$80,000
Remuneration Committee: Additional annual fees	
Chairman	HK\$60,000
Other Members	HK\$40,000

\* In line with the remuneration policy of HSBC Group, no Directors' fees are paid to those Directors who are full time employees of the Bank or its subsidiaries.

Information relating to the remuneration of each Director for 2009 is set out in Note 19 to the Bank's 2009 Financial Statements.

## ACCOUNTABILITY AND AUDIT

### Financial Reporting

The Board aims at making a balanced, clear and comprehensive assessment of the Bank's performance, position and prospects. An annual operating plan is reviewed and approved by the Board on a yearly basis. Reports on financial results, business performance and variances against the approved annual operating plan are submitted to the Board for regular discussion and monitoring at Board meetings.

Strategic planning cycles are generally from three to five years. The Bank's Strategic Plan for 2008 to 2012, following an interim review and adjustments, was reviewed by the Bank's Board in December 2009. Progress on the implementation of the Strategic Plan was reported to and reviewed by the Board on a regular basis.



The annual and interim results of the Bank are announced in a timely manner within the limits of three months and two months respectively after the end of the relevant year or period.

The Directors acknowledge their responsibilities for preparing the accounts of the Bank. As at 31 December 2009, the Directors are not aware of any material uncertainties relating to events or conditions which may cast significant doubt upon the Bank's ability to continue as a going concern. Accordingly, the Directors have prepared the financial statements of the Bank on a going-concern basis.

The responsibilities of the external auditors with respect to financial reporting are set out in the Independent Auditor's Report attached to the Bank's 2009 Financial Statements.

## **Internal Controls**

### ***System and Procedures***

The Board is responsible for internal control at the Bank and its subsidiaries and for reviewing its effectiveness.

The Bank's internal control system comprises a well-established organisational structure and comprehensive policies and standards. Areas of responsibilities for each business and functional unit are clearly defined to ensure effective checks and balances.

Procedures have been designed for safeguarding assets against unauthorised use or disposition; for maintaining proper accounting records; and for ensuring the reliability of financial information used within the business or for publication. The procedures provide reasonable but not absolute assurance against material errors, losses or fraud. Procedures have also been designed to ensure compliance with applicable laws, rules and regulations.

Systems and procedures are in place in the Bank to identify, control and report on the major types of risks the Bank faces. Business and functional units are responsible for the assessment of individual types of risk arising under their areas of responsibilities, the management of the risks in accordance with risk management procedures and reporting on risk management. The relevant risk management reports are submitted to Executive Committee, Audit Committee, Asset and Liability Management Committee, Risk Management Committee and Credit Committee, and subsequently to the Board for monitoring the respective types of risk. The Bank's risk management policies and major control limits are approved by the Board or its delegated committees, and are monitored and reviewed regularly according to established procedures of the Bank.

More detailed discussions on the policies and procedures for management of each of the major types of risk the Bank faces, including credit, market, liquidity and operational risks, are included in the risk management section of the "Financial Review" under the Bank's 2009 Annual Report, and in Note 62 to the Bank's 2009 Financial Statements.

### ***Annual Assessment***

A review of the effectiveness of the Bank's internal control system covering all controls, including financial, operational and compliance, and risk management controls, is conducted annually. The review at the end of 2009 was conducted with reference to the COSO (The Committee of Sponsoring Organisations) internal control framework, which assesses the Bank's internal control system against the five elements of control environment, risk assessment, control activities, communication and monitoring. Such annual review will also consider the adequacy of resources, qualifications and experience of staff of the Bank's accounting and financial reporting function, and their training programmes and budget. The result of the annual review has been reported to the Audit Committee and the Board.

## **Internal Audit**

The internal audit function plays an important role in the Bank's internal control framework. It monitors the effectiveness of internal control procedures and compliance with policies and standards across all business and functional units. All management letters from external auditors and reports from regulatory authorities will be reviewed by the Audit Committee and all recommendations will be implemented. Management is required to annually provide the internal audit function with written confirmation that it has acted fully on all recommendations made by external auditors and regulatory authorities. The internal audit function also advises the Management on operational efficiency and other risk management issues. The work of the internal audit function is focused on areas of greatest risk to the Bank as determined by risk assessment. The Bank's Head of Audit reports to the Chairman and the Audit Committee.

## **External Auditors**

KPMG is the Bank's external auditors. The Audit Committee is responsible for making recommendations to the Board on the appointment, reappointment, removal and remuneration of the external auditors. The external auditors' independence and objectivities are also reviewed and monitored by the Audit Committee.

During 2009, fees paid to the Bank's external auditors for audit services totalled HK\$13.4 million, compared with HK\$12.8 million in 2008. For non-audit services, the fees paid amounted to HK\$5.6 million, compared with HK\$6.5 million in 2008. In 2009, the significant non-audit service assignments covered by these fees include the following:

<b>Nature of service</b>	<b>Fees paid (HK\$m)</b>
Other assurance services	5.2
Tax services	0.4
	<hr/>
	5.6

## **Audit Committee**

The Audit Committee assists the Board in meeting its responsibilities for ensuring an effective system of internal control and compliance, and in meeting its external financial reporting obligations.

The Audit Committee held five meetings in 2009. The major work performed by the Committee during 2009 included:

- reviewing the Bank's financial statements for the year ended 31 December 2008 and the related documents, and the management letter and audit issues noted by the Bank's external auditors;
- reviewing the Bank's interim financial statements for the six months ended 30 June 2009 and the related documents, and the issues noted by the Bank's external auditors;
- reviewing the revised accounting standards and prospective changes to accounting standards, and the impact on the Bank's financial reporting;
- reviewing the implementation progress of Sarbanes-Oxley Act and Basel II;
- reviewing the internal audit plan for 2010 and monitoring the staffing and resources of the Bank's internal audit function;
- reviewing essential matters or high-level reports relating to financial control, internal audit, credit, compliance and internal control, and discussing the same with the Management;
- reviewing risk-related matters including the Bank's risk management framework, risk maps, and balance sheet management position;
- reviewing regulatory review reports and internal audit reports, and discussing the same with the Management and Head of Audit;

- reviewing the remuneration and engagement letters of external auditors, and the objectivity and independence of external auditors;
- initiating and approving the Bank's Policy for the Reporting of Improprieties by staff and monitoring its implementation and effectiveness;
- exercising enhanced oversight over the audit committees of the Bank's principal subsidiaries.

The Audit Committee meets with the Bank's external auditors and Head of Audit on a regular basis and also meets with them without the presence of the Management at least once a year. Further, the Audit Committee meets with the HKMA to maintain a regular dialogue with the regulator and to share HKMA's general views on their supervisory focus. In order to identify areas for further improvements, the Audit Committee conducts an annual gap analysis as regards the effective discharge of its role and responsibilities under its terms of reference.

## COMMUNICATION WITH SHAREHOLDERS

### Effective Communication

The Bank attaches great importance to communication with shareholders. To this end, a number of means are used to promote greater understanding and dialogue with the investment community. The Bank holds group meetings with analysts in connection with the Bank's annual and interim results. The results announcements are also broadcast live via webcast. Apart from the above, designated senior executives maintain regular dialogue with institutional investors and analysts to keep them abreast of the Bank's development. Including the two results announcements, a total of 96 meetings with 258 analysts and fund managers from 112 companies were held in 2009. In addition, the Bank's Vice-Chairman and Chief Executive; and Chief Financial Officer also made presentations and held group meetings with investors at investor forums in Hong Kong and overseas. The Bank's website [www.hangseng.com](http://www.hangseng.com) contains an investor relations section which offers timely access to the Bank's press releases and other business information.

The Annual General Meeting provides a useful forum for shareholders to exchange views with the Board. The Bank's Chairman, Executive Directors, Chairmen of the Board Committees and Non-executive Directors are available at the Annual General Meeting to answer questions from shareholders. Separate resolutions are proposed at general meetings for each substantial issue, including the re-election and election of individual Directors. An explanation of the detailed procedures of conducting a poll will be provided to shareholders at the commencement of the Annual General Meeting, to ensure that shareholders are familiar with such procedures.

The Bank's last Annual General Meeting was held on Wednesday, 6 May 2009 at 3:30 pm at Hang Seng Bank Headquarters, 83 Des Voeux Road Central, Hong Kong. All the resolutions proposed at that meeting were approved by shareholders of the Bank by poll voting. Details of the poll results are available under the investor relations section of the Bank's website at [www.hangseng.com](http://www.hangseng.com).

The next Annual General Meeting of shareholders will be held on Friday, 14 May 2010, the notice of which will be sent to shareholders at least 20 clear business days before the said meeting. Shareholders may refer to the section "Corporate Information and Calendar" in this Annual Report for information on other important dates for shareholders in year 2010.

### OTHER INFORMATION

The Annual and Interim Reports contain comprehensive information on business strategies and developments. Discussions and analyses of the Bank's performance during 2009 and the material factors underlying its results and financial position can be found in the sections "Business in Hong Kong and on the Mainland" and "Financial Review" in this Annual Report.

## **Material Related Party Transactions and Contracts of Significance**

The Bank's material related party transactions are set out in Note 61 to the 2009 Financial Statements. These transactions include those that the Bank has entered into with its immediate holding company and fellow subsidiary companies in the ordinary course of its interbank activities, including the acceptance and placement of interbank deposits, corresponding banking transactions, off-balance sheet transactions, and the provision of other banking and financial services.

The Bank uses the IT services of, and shares an automated teller machine network with, The Hongkong and Shanghai Banking Corporation Limited, its immediate holding company. The Bank also shares IT and certain processing services with fellow subsidiaries on a cost recovery basis. For 2009, the Bank's share of the costs includes HK\$174 million for system development services, HK\$193 million for data processing, and HK\$111 million for administrative services.

The Bank maintains a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. As part of its ordinary course of business with other financial institutions, the Bank also markets Mandatory Provident Fund products and distributes retail investment funds for fellow subsidiaries, with a fee income of HK\$151 million and HK\$25 million respectively in 2009. Hang Seng Investment Management Limited, a wholly owned subsidiary of the Bank, manages in the ordinary course of its business a fund administered by a fellow subsidiary, to which management fee rebates were made. The rebate for 2009 amounted to HK\$109 million.

These transactions were entered into by the Bank in the ordinary and usual course of business on normal commercial terms, and in relation to those which constituted connected transactions under the Listing Rules, they also complied with applicable requirements under the Listing Rules. The Bank regards its usage of the IT services of The Hongkong and Shanghai Banking Corporation Limited (amount of IT services cost incurred for 2009: HK\$494 million) as contracts of significance for 2009.

## **Disclosure of Continuing Connected Transactions in accordance with Rules 14A.45 and 14A.46 of the Listing Rules**

### ***Continuing Connected Transactions***

- (a) On 22 June 2007, Hang Seng Life Limited ("HSL") entered into a management services agreement ("Management Services Agreement") for an initial term of three years with HSBC Life (International) Limited ("INHK"). Pursuant to the Management Services Agreement, INHK will continue to provide certain management services, being services related to risk management, back office processing and administration, development and pricing for selected products, information technology and business recovery, financial control and actuarial services, to HSL to enable HSL to conduct its life insurance business.

INHK will charge HSL for the provision of the services on a fully absorbed cost basis plus a mark-up of 5%. These charges have been determined following negotiation on an arm's length basis and in accordance with the policy of HSBC Group, which takes into account the transfer pricing guidelines of UK and the Organisation for Economic Co-operation and Development.

- (b) On 22 June 2007, HSL also entered into an investment management agreement ("Investment Management Agreement") for an initial term of three years with HSBC Global Asset Management (Hong Kong) Limited (formerly known as HSBC Investments (Hong Kong) Limited) ("ISHK"), pursuant to which ISHK will continue to act as investment manager in respect of certain of HSL's assets held from time to time to maintain business continuity of HSL.

HSL will pay to ISHK a fee of between 0.17% and 0.375% per annum of the mean value of the assets under management, which has been determined on an arm's length basis.

HSLI has become a wholly-owned subsidiary of Hang Seng Insurance Company Limited (“HSIC”), a wholly-owned subsidiary of the Bank, since September 2007. As part of the plan of the Bank to rationalise its insurance business structure, HSLI’s long term insurance business has been integrated into that of HSIC. Accordingly, all rights and obligations under the agreements entered into between HSLI and the third parties have then been novated to HSIC. These agreements include, among others, the Management Services Agreement and the Investment Management Agreement (collectively “the Agreements”).

INHK and ISHK, both being indirect wholly owned subsidiaries of HSBC Holdings plc (“HSBC”) are connected persons of the Bank by virtue of HSBC’s indirect shareholding of shares in the Bank, representing approximately 62.14% of its issued share capital. Accordingly, the Agreements constituted continuing connected transactions for the Bank under the Listing Rules.

Details of the terms of and the annual caps under the Agreements for the years 2007, 2008 and 2009 were announced by the Bank on 22 June 2007.

Pending the renewal of the Agreements which will expire on 22 June 2010, the Bank has set the maximum value under each of the Agreements for the period from 1 January to 22 June 2010 (“2010 Part-year Cap”) pursuant to the Listing Rules.

The Company has set the 2010 Part-year Cap at HK\$85 million for the Management Services Agreement and HK\$34 million for the Investment Management Agreement. The 2010 Part-year Caps have been determined by reference to the actual fees paid to INHK and ISHK under the Agreements in years 2007 and 2008, the projected fees payable under the Agreements in year 2009, HSIC’s business and financial plans for year 2010 and the seasonal distribution of fees under the Agreements, to which an appropriate buffer to provide flexibility for possible changes in the level of services required under the Agreements has been added. The details of the 2010 Part-year Caps were announced by the Bank on 18 December 2009.

For the year ended 31 December 2009, the aggregate amounts paid under the Management Services Agreement and the Investment Management Agreement were HK\$119 million and HK\$51 million respectively.

In respect of the Agreements which constituted the Bank’s continuing connected transactions, all the Independent Non-executive Directors of the Bank have reviewed the said transactions and confirmed that the said transactions have been entered into:

- (1) in the ordinary and usual course of business of the Group;
- (2) on normal commercial terms; and
- (3) in accordance with the Agreements on terms that are fair and reasonable and in the interests of the Bank and its shareholders as a whole.

The external auditors of the Bank have also confirmed that the said transactions:

- (1) have been approved by the respective Boards of Directors of the Bank and HSIC;
- (2) have agreements in place governing the said transactions;
- (3) have been entered into in accordance with the pricing terms as set out in the Agreements or better terms from the Bank’s perspective; and
- (4) have not exceeded the annual cap amount as set out in the announcement dated 22 June 2007 released by the Bank relating to the said transactions.

## **Human Resources**

The human resources policies of the Bank are designed to attract people of the highest calibre and to motivate them to excel in their careers, as well as uphold the Bank’s brand equity and culture of quality service.

### ***Employee Statistics***

As at 31 December 2009, the Bank’s total headcount was 9,342, representing a decrease by 422, or 4.3 per cent, compared with a year earlier. The total headcount comprised 1,106 executives, 3,672 officers and 4,564 clerical and non-clerical staff.

## ***Employee Remuneration***

Compensation packages take into account levels and composition of pay in the markets in which the Bank operates. Salaries are reviewed in the context of individual and business performance, market practice, internal relativities and competitiveness compared to peers.

Under appropriate circumstances, performance-related variable pay is provided as an incentive for those staff members who had chosen to join the Bank's Annual Pay Scheme under performance-based remuneration strategy. Further, senior staff with outstanding performance were also rewarded with HSBC Group shares in 2009.

In addition, the Bank has participated in the HSBC Holdings Savings-related Share Option Plan (Sharesave), under which staff members can make monthly savings for the purchase of shares of HSBC Holdings plc after a specified period. For Sharesave 2009, 5,934 staff members had subscribed to the plan.

## ***Employee Involvement***

Communication with staff is a key aspect of the Bank's policies. Information relating to employment matters, the Bank's business direction and strategies, and factors affecting the Bank's performance are conveyed to staff via different channels, including interchange sessions, focus group meetings, an intranet site, in-house magazines, morning broadcasts and training programmes.

The third bankwide Global People Survey was conducted in June 2009 as a continuous initiative to measure staff engagement level. The results were very positive as the employee engagement index was among the best in class. Communication sessions to staff were organised to share the survey results and collect feedback for continual enhancement.

## ***Staff Development***

In order to fully develop staff capability and potential, the Bank offers a wide range of training and development programmes that help the staff fulfill their personal career goals and professional requirements, including those for regulated businesses and activities, and equip them to meet future challenges.

New staff joining the Bank will participate in a comprehensive induction programme that provides them with an understanding of the Bank's history, culture, values and corporate governance. Sustainable development of staff is enabled through multiple learning channels, including instructor-led training courses, web-based learning via an intranet platform, as well as the Bank's Learning Resource Centre. Staff members are also encouraged to pursue professional or academic qualifications through the Bank's Professional Qualifications and Education Award Scheme.

On average, our staff members received six days of training in 2009.

## ***Recruitment And Retention***

Following the financial tsunami in the second half of year 2008, the Bank had tightened the control on headcount and staff cost. In view of the gradual recovery of the economy and picking up of businesses since the third quarter of year 2009, recruitment activities have been stepped up to support business growth. Appropriate measures have been taken to ensure effective recruitment process and recruitment of the right persons.

As part of the Bank's staff retention programme, packages and career paths for certain job positions have been reviewed to increase career advancement opportunities and ensure market competitiveness. Further, trainee programmes would be provided for jobs in selected functional areas in order to build pipeline for succession.

## ***Code of Conduct***

To ensure the Bank operates according to the highest standards of ethical conduct and professional competence, all staff are required to strictly follow the Code of Conduct contained in the Bank's Staff Handbook. With reference to the applicable regulatory guidelines and other industry best practices, the Code sets out ethical standards and values to which all the Bank's staff are required to adhere and covers various legal, regulatory and ethical issues. These include topics such as prevention of bribery, dealing in securities, personal benefits, outside employment and anti-discrimination policies.

The Bank uses various communication channels to periodically remind staff of the requirement to adhere to the rules and ethical standards set out in the Code of Conduct.

## ***Health and Safety***

The Bank implements a Safety Management System with established procedures and guidelines for adherence by its staff and contractors, which helps reduce the exposure of the Bank's staff and customers to occupational safety and health risks associated with its business activities. This Safety Management System has been audited by an external Accreditation Authority and meets the registration requirements of OHSAS 18001:2007.

The Bank maintains a Contingency Plan for Communicable Disease. This sets out the key issues to be addressed and the actions to be taken by various units in the event of the occurrence of a serious communicable disease, and the arrangement of keeping adequate stock of Tamiflu by the Bank to cater for the needs of its staff in case of an outbreak of influenza pandemic. Staff have been made aware through various communication channels of the importance of personal hygiene and health, and informed of the contingency measures to be adopted. This is to ensure that the Bank will be in a position to continue with its services to the community in the event of an outbreak of a serious communicable disease.

Lastly, to promote work life balance and foster a happy workplace culture, the Bank operates a Staff Recreation Centre at Mega Site, which serves to provide its staff with various facilities for health enhancement and leisure activities.

# MANAGEMENT DISCUSSION AND ANALYSIS

## BUSINESS IN HONG KONG

Developments in Hang Seng's Hong Kong business in 2009 reflect our commitment to promoting the long-term growth of our core revenue drivers against a backdrop of difficult operating conditions.

We used our strong relationship management capabilities and comprehensive credit risk assessment system to identify good opportunities to expand our personal and commercial lending portfolios, resulting in a 4.7 per cent increase in gross advances to customers to HK\$346.6 billion.

At 31 December 2009, customer deposits, including certificates of deposit and other debt securities, were up 9.8 per cent compared with a year earlier at HK\$663.7 billion. Time deposits fell by 35.8 per cent while savings and current account deposits recorded growth of 48.4 per cent. Reduced customer appetite for investment-related products resulted in a 25.4 per cent decline in structured deposits and a 59.4 per cent drop in certificates of deposit and other debt securities.

### Personal Financial Services

Personal Financial Services recorded a 13.7 per cent drop in profit before tax to HK\$7,258 million. Operating profit excluding loan impairment charges was down 11.9 per cent at HK\$7,457 million.

Personal Financial Services' profit before tax and operating profit excluding loan impairment charges for the second half of 2009 rose by 9.3 per cent and 8.4 per cent respectively compared with the first half.

Net interest income declined by 5.8 per cent compared with a year earlier to HK\$8,195 million. Customer deposits grew by 7.4 per cent, but narrowing interest margins saw related net interest income drop by 34.7 per cent. To offset the effects of the downward pressure on deposit spreads, we deployed the commercial surplus into the prudent expansion of lending, resulting in a 7.1 per cent increase in advances to customers and a 13.7 per cent rise in related net interest income. Net interest income in the second half of the year was up 4.1 per cent compared with the first half.

Our diverse portfolio of product and service offerings and fast response to emerging market trends helped sustain wealth management business to record income for the year of HK\$4,672 million – down 2.4 per cent compared with 2008. Revenue from wealth management in the second half of 2009 was up 14.7 per cent compared with the first half, despite the implementation of new regulations requiring the physical segregation of investment and banking services.

### Investment Services

The effects of the global financial crisis dampened customer appetite for investment services in 2009.

Against the backdrop of continuing economic uncertainty in the first half, we assisted customers by focusing on capital-protected and other defensive investment products with relatively short tenors. Investor education initiatives and additional value-added services helped customers with their investment decisions and reinforced our reputation for Hong Kong and mainland China investment services expertise.

As market conditions began to stabilise, we made effective use of dedicated service channels and our time-to-market strength to achieve a 36.8 per cent rise in investment services revenue in the second half of the year compared with the first half, with broad-based improvement in investment-related income streams.

Our Securities Select Customer Trading Centre and IPO investment finance offers helped customers capitalise on the recovery in the stock market. We grew the number of securities accounts by 1.1 per cent and increased our securities trading market share. Securities turnover, which hit a 22-month high in November 2009, recorded a year-on-year rise of 25.7 per cent.

We enjoyed a good customer response to new Hang Seng-branded investment funds. Leveraging the relative resilience of the Mainland economy, we launched two new funds with China themes: the Hang



Seng Mainland and Hong Kong Corporate Bond Fund in April and the Hang Seng China 50 Index Fund in September. A good customer response to the China 50 Index Fund helped support a 15-month high in monthly investment funds sales in September. Along with the Hang Seng Global Financial Sector Bond Fund launched in August, sales of the China 50 Index Fund also drove increases of 236.1 per cent and 74.7 per cent in investment fund sales turnover and revenue respectively in the second half compared to the first half.

We expanded the features of our online margin trading services and foreign exchange-linked products to meet customer demand for yield enhancement opportunities in the low interest rate environment. Turnover of foreign exchange-linked investment deposits more than tripled compared with 2008 to exceed HK\$130 billion.

In August, we became the first Hong Kong financial institution to achieve a dual listing of exchange-traded funds (ETFs) – the Hang Seng Index ETF and the Hang Seng H-Share Index ETF – in Taiwan. This development allows Taiwanese investors to directly invest in Hang Seng ETFs available in the Hong Kong market, increasing our profile in Taiwan and opening up a new avenue of future business. Other moves to expand our visibility in overseas markets include the distribution of the Hang Seng Islamic China Index Fund in several countries in the Middle East.

With subdued levels of investor activity, Private Banking focused on strengthening its relationship management team and enhancing investment services support with the aim of taking good advantage of medium and long-term business opportunities. These efforts were recognised with a Best Local Private Bank – Hong Kong award in the peer-determined 2010 Private Banking Awards organised by *Euromoney*.

Overall, investment income dropped by 23.2 per cent for 2009. The 15.2 per cent growth in revenue from stockbroking and related services was more than offset by reduced income from investment funds and structured investment products, which fell by 49.1 per cent and 57.1 per cent respectively. Private Banking service fee income dropped by 38.9 per cent.

### ***Insurance Services***

With customers shifting their focus to more traditional and protection-based life insurance, we enhanced existing products and launched new ones to offer coverage for a diverse range of situations at all life stages.

Competition in the life insurance sector increased during the second half of the year. We implemented a series of promotional campaigns, leveraged our expanded product portfolio and emphasised our good needs-based analysis capabilities that help customers attain highly personalised insurance solutions.

Medical coverage targeting younger customer segments included a Refundable Cancer Protection Plan, launched in July, that offers a 100 per cent premium refund at policy maturity.

With an increased proportion of new business coming from protection products, we achieved a more balanced insurance portfolio mix, providing a broader platform for future business growth.

Total policies in-force rose by 10.1 per cent in 2009 and annualised premiums increased by 14.7 per cent to HK\$13.7 billion.

Life insurance income was up 46.8 per cent at HK\$1,934 million, due mainly to our effective management of the life insurance funds investment portfolio, as well as the increase in net interest income arising from the growth in the portfolio and asset reallocation.

### ***Consumer Lending***

At 31 December 2009, lending to individuals was up 7.1 per cent compared with a year earlier, driven mainly by residential mortgage lending and good growth in our credit card business. Excluding the fall in Government Home Ownership Scheme (GHOS) mortgages, lending to individuals rose by 9.3 per cent.

Customer acquisition and card utilisation campaigns underpinned the 6.5 per cent expansion of our credit card base to 1.85 million cards in use and we increased our market share. Card receivables and spending rose by 7.6 per cent and 9.1 per cent respectively.

Personal loans grew by 9.3 per cent year-on-year, with the total loan balance reaching HK\$3.6 billion.

With low interest rates, the property market was highly active during 2009, but competition for residential mortgage business remained keen. In August, we added to our stable of mortgage loan offerings with the launch of a switchable HIBOR mortgage. Along with our convenient e-Mortgage channel, our diverse range of mortgage loan products helped us retain a strong position in this competitive sector and achieve an impressive 11.7 per cent increase in residential mortgage lending to individuals (excluding GHOS mortgages). Our market share at 2009 year-end was 15.1 per cent.

Loan impairment charges rose by 30.8 per cent compared with 2008, but good management of customer relationships and improvements in unemployment and bankruptcy trends saw credit quality improve towards the end of the year, with loan impairment charges down by 34.3 per cent in the second half compared to the first half.

## **Commercial Banking**

Operating profit excluding loan impairment charges fell by 15.5 per cent to HK\$1,989 million, due mainly to a drop in net interest income. Profit before tax was up 6.8 per cent at HK\$2,637 million, reflecting the 67.4 per cent reduction in loan impairment charges compared with 2008.

We continued to assist small and medium-sized enterprises in Hong Kong through our participation in government-guaranteed lending schemes, under which we have now approved over 5,000 applications with loans totalling more than HK\$14.2 billion. Facilities granted under these schemes helped drive a 12.1 per cent rise in advances to customers.

Despite the slowdown in import-export trade, we maintained steady trade finance business, which grew by 3.3 per cent. We expanded our network of credit insurers – strengthening our factoring capabilities and creating a good foundation for business growth as market conditions improve.

With increasing competition amongst lenders towards the end of 2009, we emphasised customer support services and response times over price in competing for business. In April, our reputation as a preferred business partner for commercial customers was underlined with our fourth consecutive SME's Best Partner award from the Hong Kong Chamber of Small and Medium Business.

At 31 December 2009, advances to customers were up 12.1 per cent compared with the previous year-end. Along with improved loan spreads, this growth underpinned the 15.4 per cent increase in net interest income from lending.

The establishment of a dedicated deposit service team drove a 26 per cent increase in deposits, but this only partly offset the effects of narrowing deposit spreads, with related net interest income falling by 47.7 per cent.

Overall, net interest income was HK\$2,011 million – down 16.6 per cent.

In the face of growing competition for lending business and shrinking deposit margins, we took further steps to diversify our revenue base and develop streams of non-interest income.

Strong customer relationships and an enhanced product portfolio sustained corporate wealth management business flows, with income down a modest 1.8 per cent despite weak investment sentiment.

We offered customers insurance coverage against potential disruptions to their business operations. Lower-risk investment products provided yield-enhancement opportunities against the backdrop of low deposit interest rates.

Our Executive Retention Insurance Plan launched in late 2009 helps companies retain high-value employees by enhancing their compensation and benefits packages. Strong sales of a key-person insurance product underpinned the 103.1 per cent increase in corporate life insurance income and

drove a significant improvement in the penetration rate for insurance among commercial customers. We will continue to expand key-person and other employee-related insurance and investment offerings for commercial and corporate customers.

We placed our investment sales focus on capital-protected and lower-risk enhanced-yield deposits, achieving record sales turnover in foreign exchange-linked deposits. Riding on the improving outlook of investors in the second half, we stepped up promotion of investment funds and securities trading services as well as treasury hedging solutions. Investment income for the year was down 23.9 per cent, but the second half showed a 47.4 per cent improvement compared with the first half.

In July, we launched a number of cross-border renminbi services following the Central Government's announcement of a pilot cross-border renminbi trade settlement scheme in five Mainland cities. Towards the end of the year, we signed an agreement with China Export and Credit Insurance Corporation that strengthens our ability to offer one-stop buyer credit protection and accounts receivable finance solutions.

Along with good business synergy between Hang Seng Commercial Banking teams in Hong Kong and on the Mainland and new business relationships with strategic Mainland partners, our enhanced trade settlement capabilities put us in a better position to capture an increasing share of cross-border business flows.

## **Corporate Banking**

Corporate Banking achieved a 20.1 per cent increase in operating profit excluding loan impairment charges to HK\$979 million.

Net operating income before loan impairment charges was up 15.3 per cent at HK\$1,311 million – due mainly to the 17.2 per cent growth in net interest income.

Net interest income from advances grew by 41.5 per cent. At 31 December 2009, Corporate Banking's loan balance was down 5.6 per cent compared with a year earlier, reflecting weaker investment appetite and stronger financial discipline by corporate customers during the international financial crisis. We used our in-depth understanding of local markets and balance sheet strength to provide companies facing a challenging economic environment with loans at risk-adjusted rates of return. Our continuing support further enhanced customer loyalty – enabling us to maintain good loan asset portfolios during the second half of the year as conditions for lenders became more competitive.

Customer preference for liquidity saw current and savings account deposits grow by 56.1 per cent, but time deposits drop by 40.8 per cent, resulting in a 9.4 per cent decline in total deposits and a 36.4 per cent fall in related net interest income.

We leveraged our strong customer relationships to open more customer investment accounts, providing a good springboard for the future growth of corporate wealth management business in support of greater income diversification.

The improved loan assets portfolio helped drive a 61.2 per cent reduction in loan impairment charges, underpinning a 46.7 per cent rise in operating profit to HK\$901 million. Profit before tax was up 41.9 per cent at HK\$915 million.

## **Treasury**

Treasury's operating profit excluding credit risk provisions declined by 3.9 per cent to HK\$2,918 million.

Net interest income fell by 19.4 per cent to HK\$2,162 million. Low interest rates and ample liquidity in the market kept the cost of funds down but also limited yields on new deployments of funds and balance sheet management portfolio investments.

We maintained a prudent approach to risk management, enhancing the portfolio mix by investing in high-quality debt securities – particularly government-guaranteed papers and corporate securities from quality issuers – that offer relatively low credit risk but reasonable yields. As market conditions changed, we took advantage of appropriate opportunities to dispose of certain negotiable instruments.

While these disposals were in line with our risk management strategy, the resulting HK\$152 million disposal loss partly offset growth in net operating income.

Net trading income grew by 64.4 per cent to HK\$1,054 million, due mainly to a HK\$462 million net increase in funding swap income.

We took further steps to enhance the infrastructure that supports Treasury's customer-driven business with the aim of strengthening product development capabilities, service delivery and sales synergy with other customer groups. With reduced investor appetite for equity and interest rate-linked products, we focused on enhancing and promoting foreign exchange-linked investments.

The improved credit quality of the balance sheet management portfolio resulted in a HK\$1,373 million reduction in credit risk provisions compared with 2008. This underpinned the 66.8 per cent increase in net operating income after credit risk provisions to HK\$3,184 million. Treasury's profit before tax increased by 48.9 per cent to HK\$3,393 million.

## **Technology**

We remain committed to investing in technology to provide customers with fast, convenient and secure access to financial services.

We moved forward with plans for expanding our network of self-service banking facilities in high-traffic locations. New touch-screen technology and streamlined transaction processes on our ATM terminals helped shorten waiting times for customers. Additions to our range of Internet and mobile phone-based services and a series of promotional campaigns and attractive pricing offers encouraged migration to online and automated channels.

We continued to take a lead in leveraging the Internet to provide convenient and environmentally friendly services – including e-Priority booking for Bank-sponsored concerts and a secure e-Token top-up service under our Green Banking account – to increase our appeal among young people.

In December 2009, 79.9 per cent of customer transactions were completed using self-service and automated channels.

Our growing range of Personal e-Banking investment services helped customers take advantage of opportunities for yield enhancement in rapidly changing market conditions. We expanded the types of commodities accounts and investment deposit services available online. In October, we launched an Internet-based renminbi bond IPO service to capitalise on a growing area of investor interest.

With increasing emphasis on timely access to financial information and services, we rolled out an improved version of our website designed specifically for the strategically important mobile phone platform. The popularity of our new mobile phone-based travel insurance application service Mobile Travelsure – the first such service in Hong Kong – helped drive a 23 per cent increase in the value of gross written insurance premiums generated through e-channels compared with 2008. Personal e-Banking's total online transaction revenue rose by 21 per cent.

At the end of 2009, the number of Personal e-Banking customers had reached over 980,000 – up 12.8 per cent compared with a year earlier. Customers continued to support our environmental efforts, with a 54.5 per cent increase in the number of accounts enrolled in the e-Statement service to reach over 330,000 by year-end.

We continued to enhance our Business e-Banking proposition, including the launch of online investment fund trading services towards the end of the year. At 31 December 2009, the number of Business e-Banking customers was up 19 per cent compared with a year earlier at more than 77,000. The number of transactions completed via Business e-Banking increased by 13.3 per cent compared with 2008.

## **Hang Seng Indexes**

Wholly owned subsidiary Hang Seng Indexes Company Limited (Hang Seng Indexes) expanded its services in 2009 with the launch of new indexes to support continuing strong interest in China and further assist investors in monitoring the performance of various market sectors.

Hang Seng Indexes now compiles 96 publicly available indexes – 47 real-time price indexes and 49 daily indexes – of which 40 track the Mainland segment of the market. In addition to its publicly available indexes, Hang Seng Indexes also compiles customised indexes to serve the specific indexing needs of various clients.

A new data licensing agreement signed with the Shenzhen Stock Exchange in September complemented a similar arrangement made with the Shanghai Stock Exchange in 2007 to expand Hang Seng Indexes' coverage to include all listed companies in mainland China. The launch of the Hang Seng China A Industry Top Index – Hang Seng Indexes' first index to focus solely on A share companies – followed this development. The Hang Seng China A Industry Top Index reflects the performances of Mainland-listed industry leaders in each of the 11 industries under the Hang Seng Industry Classification System, selecting a maximum of five companies from each industry based on market capitalisation and fundamental factors including revenues and net profits.

In October, Hang Seng Indexes' experience and expertise in Hong Kong and Mainland markets was recognised with a Best Local Provider of Indexes in Asia award at *AsianInvestor's* 2009 Service Providers Awards.

In November, Hang Seng Indexes marked the 40th anniversary of the public launch of the Hang Seng Index (HSI) and unveiled plans to revamp the Hang Seng Family of Indexes. Effective 8 March 2010, overlapping indexes in the index family will be discontinued and new indexes will be introduced to meet investor needs. The indexes will be re-grouped into four categories – Flagship Indexes, Benchmark Indexes, Thematic Indexes and Strategy Indexes – and also by the geography of their constituents – Hong Kong, cross-market and Mainland. Index methodologies of the Benchmark and Thematic Indexes will be enhanced to better reflect market trends.

In 2009, the Hang Seng Mainland 25 Index and the HSI Short Index were used as the underlying indexes for ETFs for the first time. Including ETFs that track the HSI and the Hang Seng China Enterprises Index, the total assets under management of the eight ETFs listed in different regions that track indexes compiled by Hang Seng Indexes was more than HK\$93 billion in 2009 – up 55 per cent compared with the previous year.

# MANAGEMENT DISCUSSION AND ANALYSIS

## BUSINESS ON THE MAINLAND

Mainland China is central to our long-term growth strategy.

In 2009, we extended our reach in this important market by opening more sub-branches under Hang Seng Bank (China) Limited as well as strengthening existing strategic alliances and establishing new ones. Close collaboration between Hang Seng staff on the Mainland and in Hong Kong led to the expansion of our wealth management business and an enhanced proposition for commercial customers with cross-border financial services needs.

These developments drove good growth in both personal and commercial customer bases, with the total number of Mainland customers up 18.3 per cent compared with the end of 2008.

Hang Seng China's total operating income was up 3.9 per cent, underpinned by the 1.3 per cent rise in net interest income. Reduced exchange losses on the revaluation of US dollar funds held by Hang Seng China against the renminbi were partly offset by the decline in other non-interest income.

We achieved good cost containment through the effective deployment of resources, recording a 0.9 per cent reduction in operating expenses despite expanding our network of outlets during the year.

The growth in the Mainland customer base underpinned a 35.9 per cent increase in deposits. Against the backdrop of the global financial crisis, the Central Government's RMB4 trillion stimulus package helped the Mainland economy maintain good momentum. Continuing economic activity and the more relaxed policy environment created new opportunities for banks to grow their lending business – particularly during the first half of the year – but also put downward pressure on pricing. We maintained good credit control, with loan quality rather than portfolio expansion remaining our primary consideration in lending decisions. At 31 December 2009, advances to customers were up 5.2 per cent compared with a year earlier.

Hang Seng China's profit before tax recorded steady growth, reflecting the rise in total operating income as well as lower loan impairment charges and operating expenses.

Including the share of profit from strategic partners Industrial Bank and Yantai Bank, Mainland business contributed 13.3 per cent to total profit before tax, up from 11.9 per cent in 2008.

### Services

Good use of strategic partnerships and further investments in our service delivery channels helped us reach a broader group of potential customers. We expanded and upgraded our online propositions for personal and commercial banking to attract new business by promoting our Internet services as a fast and effective way for customers to manage their financial needs.

Alliances with Mainland financial services organisations also provided greater customer convenience and supported the broadening of our service scope. We maintained agreements with several insurance companies to offer a diverse range of insurance coverage options and cooperated with estate agents and a mortgage guarantee company to strengthen our mortgage loan business.

Commercial Banking continued to benefit from our well-established relationships with customers in Hong Kong and close cooperation between colleagues across our markets of operation. We introduced a comprehensive range of renminbi cross-border trade settlement services following the implementation of the Central Government's pilot cross-border renminbi trade settlement scheme in mid 2009. By 31 December, our branch in Dongguan had handled 25.3 per cent of all cross-border renminbi settlements by value in the city – ranking first for cross-border renminbi settlements business in the last two months of 2009. New agreements with the China Export and Credit Insurance Corporation enable us to offer buyer credit protection, accounts receivable finance solutions and export credit insurance. These developments helped drive the 10.9 per cent increase in the number of Mainland commercial customers.

The January 2009 launch of two Hang Seng China renminbi debit cards – the Hang Seng Card and Hang Seng Prestige Banking Card – was complemented by an agreement with China UnionPay (CUP) that allows the cards to be used at ATMs bearing the CUP logo as well as at designated CUP merchants on the Mainland and in about 50 countries and regions across the world. The agreement also enables all CUP-standard cards to be used in Hang Seng China ATMs, providing valuable brand exposure. Hang Seng China customers can access their accounts via 136 HSBC China ATMs.

Drawing in part on Hang Seng's experience and capabilities in Hong Kong, we launched a series of wealth management seminars in support of improved investor education and continued to refine our investment product portfolio to meet changing customer needs and risk appetites in uncertain markets.

We achieved a 25.2 per cent increase in the number of Prestige Banking customers in 2009, providing a strong base from which to deepen relationships through increased product penetration and cross-selling.

Our efforts have won external recognition, with Hang Seng China receiving the Most Popular Foreign Bank and Best Wealth Management Bank Awards at the 5<sup>th</sup> Beijing International Finance Expo. Our equity-linked partially capital protected investment product 'Easy Touch – Auto-callable' was named the Best Structured Financial Product in 2009 by *Shanghai Securities News*.

## **Network**

Focusing on enhancing our coverage and customer convenience in cities with high growth potential, we opened three new outlets in 2009.

A new sub-branch in Beijing is supporting our business activity in the Bohai Economic Rim Region.

New sub-branches in Shenzhen and Guangzhou are facilitating the expansion of our cross-border renminbi trade settlement service capabilities. In January this year we opened a cross-city sub-branch in Foshan following the implementation of Supplement VI to the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) in October 2009, which allows Hong Kong banks with branch outlets in Guangdong to apply to establish sub-branches in any municipality within the province.

We now have three branches and 13 sub-branches in the Pearl River Delta region. Along with our enhanced trade settlement capabilities, this puts us in a good position to capture a growing share of cross-border business flows.

Including our Foshan cross-city sub-branch, Hang Seng China currently operates a network of 37 outlets and 66 ATMs across 12 Mainland cities.

## **Strategic Alliances**

Long-term strategic partnerships provide an important complement to Hang Seng China's operations in our plan for the sustainable growth of our Mainland business.

Our strategic alliance with Industrial Bank – which reached its fifth anniversary in April 2009 – continues to yield good results. We continue to collaborate in areas such as wealth management and trade services, and have strengthened mechanisms for cross-referring business.

Our strategic cooperation with new partner Yantai Bank in Shandong province is helping to strengthen our presence in the economically important Bohai Economic Rim region.

## **Future Growth**

We have a broad-based vision for our Mainland business that emphasises the importance of a comprehensive product portfolio, personalised wealth management solutions, efficient delivery and convenient access to services.

Deposits acquisition, particularly renminbi deposits, remains a central part of our strategy for long-term growth, underpinning balance sheet strength and providing liquidity for future business expansion as markets become more stable.

In support of this objective, we will continue to target the affluent customer segment, leveraging our Prestige Banking brand. We will further enhance our wealth management offerings and use staff training to improve our sales and service capabilities, with the aim of offering customised financial solutions. This will also support efforts to grow our fee-based business for the greater diversification of revenue streams.

With our large base of commercial customers in Hong Kong and growing portfolio of renminbi trade settlement services, the focus of Hang Seng China's recent network expansion sees us better positioned to take advantage of increasing cross-border business opportunities. We will leverage this position to further strengthen our platform for achieving sustainable deposits growth.

We will continue to enhance risk management and operational efficiency and take advantage of the new opportunities for business created by CEPA VI.

Through Hang Seng China, we will engage in more brand-building activities, leverage our network of strategic partnerships and expand services that target key customer segments to support the continued expansion of our Mainland operations.

Following on from our strategic shareholdings in Industrial Bank and Yantai Bank, we are actively seeking potential investment opportunities in wealth management industry partners on the Mainland.



# MANAGEMENT DISCUSSION AND ANALYSIS

## FINANCIAL REVIEW

### FINANCIAL PERFORMANCE

#### Income Statement

##### Summary of financial performance

Figures in HK\$m

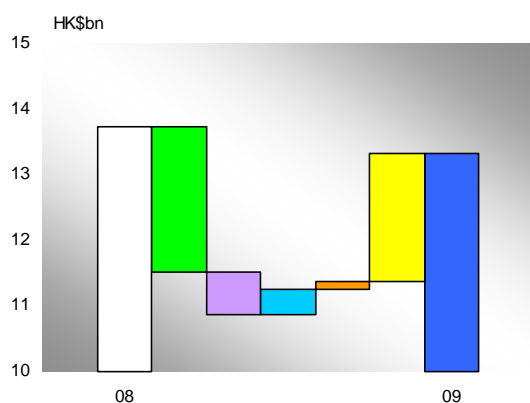
	<u>2009</u>	<u>2008</u>
Total operating income	32,816	34,759
Total operating expenses	6,676	6,795
Operating profit after loan impairment charges and other credit risk provisions	13,324	13,725
Profit before tax	15,477	15,878
Profit attributable to shareholders	13,221	14,099
Earnings per share (in HK\$)	6.92	7.37

Hang Seng Bank Limited ('the Bank') and its subsidiaries and associates ('the Group') reported an audited profit attributable to shareholders of HK\$13,221 million for 2009, down by 6.2 per cent compared with 2008. Earnings per share were HK\$6.92, down HK\$0.45 from 2008. Attributable profit to shareholders for the second half of 2009 rose by HK\$319 million, or 4.9 per cent, when compared with the first half.

**Operating profit excluding loan impairment charges and other credit risk provisions fell by HK\$2,365 million, or 14.3 per cent, to HK\$14,136 million.**

Although the economic environment in Hong Kong began to show signs of gradual recovery and market sentiment improved during the second half of the year, operating conditions in 2009 were challenging. The continuing low interest rate environment had a significant adverse impact on net interest income. Non-interest income also fell although there was notable growth in the second half of the year compared with the first half. Operating expenses were contained at a lower level than in 2008.

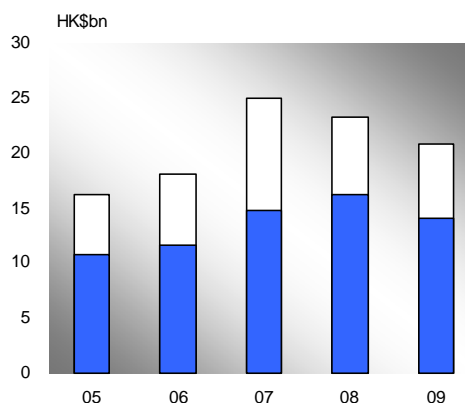
#### OPERATING PROFIT ANALYSIS



	HK\$m
□ 2008 OPERATING PROFIT	13,725
CHANGES DUE TO :	
■ NET INTEREST INCOME	(2,209)
■ NET FEE INCOME	(648)
■ OTHER OPERATING INCOME	373
■ OPERATING EXPENSES	119
■ LOAN IMPAIRMENT CHARGES AND OTHER CREDIT RISK PROVISIONS	1,964
■ 2009 OPERATING PROFIT	<u>13,324</u>

#### NET OPERATING INCOME

(Before loan impairment charges and other credit risk provisions)



■ NET OPERATING INCOME
□ NON-INTEREST INCOME
■ NET INTEREST INCOME

**Net interest income fell by HK\$2,209 million, or 13.6 per cent, due mainly to the adverse impact of the low interest rate environment.**

<i>Figures in HK\$m</i>	<u>2009</u>	<u>2008</u>
Net interest income/(expense) arising from:		
- financial assets and liabilities that are not at fair value through profit and loss	14,151	17,277
- trading assets and liabilities	(234)	(1,211)
- financial instruments designated at fair value	<u>106</u>	<u>166</u>
	<u>14,023</u>	<u>16,232</u>
Average interest-earning assets	736,953	688,252
Net interest spread	1.84%	2.15%
Net interest margin	1.90%	2.36%

While average interest-earning assets increased by HK\$48.7 billion, or 7.1 per cent, funds were deployed into high quality but low yield liquid assets to reduce risk. Net interest income was also affected by the repricing of assets due to the decline in interest rates.

Net interest margin decreased by 46 basis points to 1.90 per cent compared with 2008. Net interest spread declined by 31 basis points to 1.84 per cent, attributable mainly to compressed deposit margins in the low interest rate environment which offered little room for the reduction of interest rates paid to customers. Treasury balance sheet management income was also affected by the repricing of assets as interest rates fell. Volume growth was noted in the average balance of mortgage lending, offsetting the effect of tighter spreads on mortgages in an intensely competitive market. The increase in the higher-yielding credit card business also helped support net interest income revenue streams. The Group has grown its life insurance business and changed the mix of the assets held in the life insurance funds investment portfolio to held-to-maturity securities, increasing its contribution to interest income by 38.1 per cent compared with 2008.

The contribution from net free funds dropped by 15 basis points to 0.06 per cent as a consequence of the low interest rate environment.

The HSBC Group reports interest income and interest expense arising from financial assets and financial liabilities held for trading as 'Net trading income'. Income arising from financial instruments designated at fair value through profit and loss is reported as 'Net income from financial instruments designated at fair value' (other than for debt securities in issue and subordinated liabilities, together with derivatives managed in conjunction with them).

The table below presents the net interest income of Hang Seng, as included within the HSBC Group accounts:

<i>Figures in HK\$m</i>	<u>2009</u>	<u>2008</u>
Net interest income	14,137	17,233
Average interest-earning assets	670,321	664,750
Net interest spread	2.06%	2.34%
Net interest margin	2.11%	2.59%

**Net fee income fell by HK\$648 million, or 13.0 per cent, to HK\$4,321 million, compared with 2008.**

Although the economic environment began to improve in the second half of 2009, investor demand for retail investment funds and structured investment products remained weak, resulting in declines in income of 44.3 per cent and 91.8 per cent respectively. Income from stockbroking and related services registered encouraging growth of 15.2 per cent on the back of the 25.7 per cent increase in stock trading turnover – a significant outperformance of the Hong Kong stock market. Private banking services fee income fell, reflecting reduced customer appetite for trading and structured investment

products.

Card services income was 8.4 per cent higher than in 2008 and was broadly in line with the growth in average card balances. The Bank's effective customer loyalty scheme and card utilisation promotions helped drive up Hang Seng card spending in 2009 to outperform the shrinking market. The increase in card income was also supported by year-on-year increases of 6.5 per cent in the number of cards in circulation and 9.1 per cent in cardholder spending.

Insurance fee income rose by 93.9 per cent, mainly contributed by strong sales of the HSBC Jade Global Universal Life product.

Compared with the first half of 2009, net fee income grew by HK\$469 million, or 24.4 per cent, in the second half, partly reflecting increased demand for wealth management products coupled with renewed activity in the stock market. Higher income was recorded from retail investment funds with the timely launch of a China Index-linked fund and a global high-yield bond fund. Income from stockbroking and related services benefitted from the rebound in the stock market and increased IPO activity. Income from card services, private banking and trade services also registered solid growth in the second half of 2009 as compared to the first half.

**Trading income rose significantly by HK\$468 million, or 32.2 per cent, to HK\$1,923 million.**

Foreign exchange income increased by 29.5 per cent, mainly due to the combined effect of the favourable increase in net interest income from funding swaps<sup>†</sup> and the reduction in exchange losses on Hang Seng China's US dollar capital funds upon revaluation against the renminbi. Normal foreign exchange trading, however, fell by 14.2 per cent.

Income from securities, derivatives and other trading activities increased by HK\$60 million, or 84.5 per cent. This was the net result of the improvement in securities trading activities and the decreased customer appetite for equity-linked structured products.

<sup>†</sup> *Treasury from time to time employs foreign exchange swaps for its funding activities, which in essence involve swapping a currency ('original currency') into another currency ('swap currency') at the spot exchange rate for short-term placement and simultaneously entering into a forward exchange contract to convert the funds back to the original currency on maturity of the placement. In accordance with HKAS39, the exchange difference of the spot and forward contracts is required to be recognised as foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.*

**Financial instruments designated at fair value reported a net loss of HK\$75 million, improved by HK\$956 million, or 92.7 per cent, when compared with 2008.**

This was mainly due to the improved financial markets in 2009 and the switching of the equity component of the investment assets of the life insurance funds investment portfolio for high-quality debt securities in the second half of 2008.

**Net earned insurance premiums fell by HK\$832 million, or 6.7 per cent. Net insurance claims incurred and movement in policyholders' liabilities rose by HK\$541 million, or 4.7 per cent.**

## Analysis of income from wealth management business

Figures in HK\$m

	2009	2008
Investment income:		
- retail investment funds	604	1,084
- structured investment products <sup>†</sup>	473	882
- private banking service fee <sup>††</sup>	158	248
- stockbroking and related services	1,566	1,359
- margin trading and others	141	119
	<b>2,942</b>	<b>3,692</b>
Insurance income:		
- life insurance	2,070	1,383
- general insurance and others	337	314
	<b>2,407</b>	<b>1,697</b>
Total	<b>5,349</b>	<b>5,389</b>

<sup>†</sup> Income from structured investment products includes income reported under net fee income on the sales of third-party structured investment products. It also includes profit generated from the selling of structured investment products in issue, reported under trading income.

<sup>††</sup> Income from private banking includes income reported under net fee income on investment services and profit generated from selling of structured investment products in issue, reported under trading income.

Wealth management business income was broadly in line with 2008, falling by HK\$40 million, or 0.7 per cent. The investment climate in 2009 remained weak, although there was an upturn in demand for wealth management products during the second half of the year. To cater for changing customer demands in uncertain financial markets, the Group rapidly shifted its focus to personal insurance protection and lower-risk investment products. This resulted in an encouraging growth of 41.8 per cent in insurance income which partly offset the 20.3 per cent decline in investment income.

Income from retail investment funds and structured products was adversely affected by the unfavourable investment climate and equity markets volatility that took hold in the second half of 2008. However, as economic conditions stabilised during 2009, effective actions to support improving investor sentiment led to a solid increase in investment income in the second half of the year compared with the first half. The Bank capitalised on opportunities to promote yield-enhancing investment products in the context of the low interest rate environment. The launch of the Hang Seng China Index Linked Fund and Hang Seng Global Financial Sector Bond Fund boosted investment funds sales during the second half but this only partly offset the overall decline in demand for investment funds, with investment funds turnover and income 41.0 per cent and 44.3 per cent respectively for the year. Structured investment products income declined by 46.4 per cent.

Income from stockbroking and related services rose by 15.2 per cent on the back of the Bank's efforts to grow its market share to capitalise on the stock market rebound in the second half of 2009. The Bank captured additional sales opportunities by offering professional and convenient trading services to customers via its new Securities Select Customer Trading Centre. These efforts helped increase year-on-year securities turnover by 25.7 per cent.

Private Banking service fee income was lower than in 2008, affected by the weak investment sentiment and lower volume of customer transactions. The Bank expanded its business by strengthening its relationship management team, enhancing investment services support and implementing a variety of wealth management initiatives that will ensure it can take better advantage of medium and long-term business opportunities.

To meet customers' increased focus on wealth preservation in the changing economic conditions, the Group diversified its insurance product range and introduced new plans with improved protection propositions. In the intensely competitive operating environment, the Group recorded an increase in renewal business but new business declined, with net earned life insurance premiums down by 6.9 per cent. With the Bank having shifted the portfolio mix away from equities to debt securities in the second half of 2008, the investment returns improved from an investment loss of HK\$1,065 million in 2008 to an investment gain of HK\$17 million in 2009. Net interest income and fee income from the life insurance funds investment portfolio rose by 43.7 per cent, contributed by the growth in the life

insurance funds investment portfolio and asset reallocation. The increase more than offset the rise in net insurance claims incurred and movement in policyholders' liabilities.

General insurance income increased by 7.3 per cent to HK\$337 million.

Figures in HK\$m

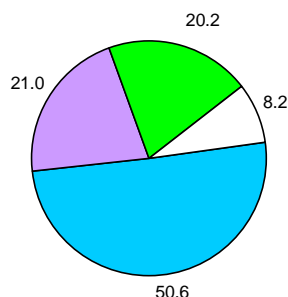
	2009	2008
Life insurance:		
- net interest income and fee income	2,012	1,400
- investment returns on life insurance funds	17	(1,065)
- net earned insurance premiums	11,193	12,023
- net insurance claims incurred and movement in policyholders' liabilities <sup>†</sup>	(11,912)	(11,357)
- movement in present value of in-force long-term insurance business	760	382
	<b>2,070</b>	1,383
General insurance and others	<b>337</b>	314
Total	<b>2,407</b>	1,697

<sup>†</sup> Including premium and investment reserves

Operating expenses fell by HK\$119 million, or 1.8 per cent, to HK\$6,676 million.

OPERATING EXPENSES FOR 2009

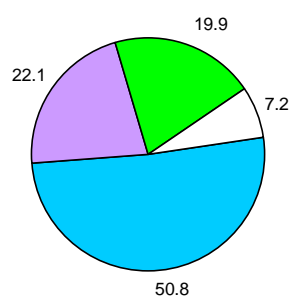
IN PERCENTAGE



■ EMPLOYEE COMPENSATION AND BENEFITS  
 ■ OTHER OPERATING EXPENSES  
 ■ PREMISES AND EQUIPMENT  
 □ DEPRECIATION AND AMORTISATION

OPERATING EXPENSES FOR 2008

IN PERCENTAGE



Operating expenses fell by HK\$119 million, or 1.8 per cent, compared with 2008, reflecting lower staff-related expenses and the Bank's well-managed cost control in the difficult operating environment. Excluding Mainland business, operating expenses fell by 2.0 per cent.

Employee compensation and benefits decreased by HK\$74 million, or 2.1 per cent. Salaries and other costs decreased by 3.7 per cent, reflecting the decline in average headcount and other staff-related costs. Performance-related pay expenses dropped by 18.4 per cent. Retirement benefit costs increased, due mainly to a reduction in the expected investment return for 2009. General and administrative expenses decreased by 3.6 per cent, with close cost management in marketing and advertising partly offset by rising rental expenses. Depreciation charges rose by 7.9 per cent, reflecting the acquisition of equipment, fixtures and fittings for the Bank's Kowloon Bay office and head office in Central.

Staff numbers<sup>†</sup> by region

	2009	2008
Hong Kong	7,834	8,256
Mainland	1,449	1,450
Others	59	58
Total	<b>9,342</b>	9,764

<sup>†</sup> Full-time equivalent

At 31 December 2009, the Group's number of full-time equivalent staff was down by 422 compared with the end of 2008 – with the reduction mainly at the Group's Hong Kong operations. The number of staff was closely monitored and headcount in Hong Kong was gradually reduced through natural attrition. Headcount for the Bank's Mainland operations remained stable.

The cost efficiency ratio for 2009 was 32.1 per cent, compared with 29.2 per cent for 2008, with the increase in the ratio due primarily to the reduction in net operating income before impairment charges and other credit risk provisions.

**Loan impairment charges and other credit risk provisions improved significantly, falling by HK\$1,964 million, or 70.7 per cent, to HK\$812 million,** with good credit risk management and improving economic conditions in the second half of 2009.

<i>Figures in HK\$m</i>	<b>2009</b>	<b>2008</b>
Loan impairment charges:		
- individually assessed	(310)	(925)
- collectively assessed	<u>(502)</u>	<u>(476)</u>
	<u>(812)</u>	<u>(1,401)</u>
of which:		
- new and additional	(1,104)	(1,505)
- releases	230	48
- recoveries	<u>62</u>	<u>56</u>
	<u>(812)</u>	<u>(1,401)</u>
Other credit risk provisions	<u>-</u>	<u>(1,375)</u>
Loan impairment charges and other credit risk provisions	<u>(812)</u>	<u>(2,776)</u>

With no impairment losses against available-for-sale securities, other credit risk provisions were down significantly when compared with 2008, which saw a HK\$1,375 million write down of the carrying value of certain available-for-sale debt securities in the second half of the year.

Individually assessed provisions fell by HK\$615 million due mainly to lower new and additional impairment charges and a higher net release on the accounts of certain corporate and commercial banking customers. The mortgage portfolio continued to be well secured with an average loan-to-value ratio below 40 per cent.

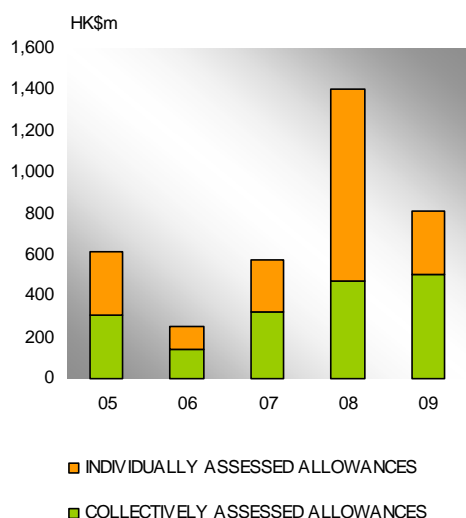
Collectively assessed provisions rose slightly by HK\$26 million, reflecting a rise in credit card delinquencies against the backdrop of higher card spending and the uncertain economic environment. Impairment provisions for personal loan portfolios also increased modestly.

Total loan impairment allowances as a percentage of gross advances to customers are as follows:

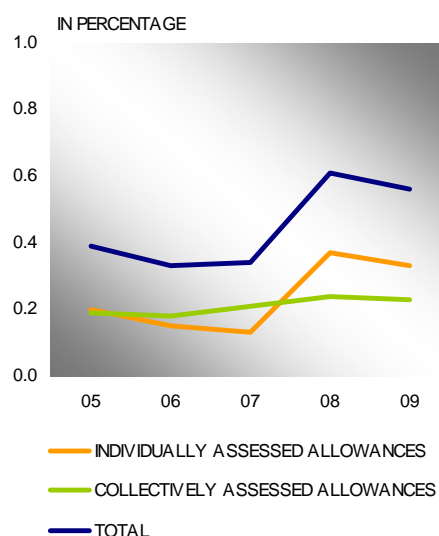
	<b>2009</b>	<b>2008</b>
	%	%
Loan impairment allowances:		
- individually assessed	0.33	0.37
- collectively assessed	<u>0.23</u>	<u>0.24</u>
Total loan impairment allowances	<u>0.56</u>	<u>0.61</u>

**Operating profit** was down HK\$401 million, or 2.9 per cent, at HK\$13,324 million.

### NET CHARGES FOR LOAN IMPAIRMENT ALLOWANCES



### LOAN IMPAIRMENT ALLOWANCES AS A PERCENTAGE OF GROSS ADVANCES TO CUSTOMERS



**Profit before tax** fell by 2.5 per cent to HK\$15,477 million, after taking into account a HK\$140 million increase in **net surplus on property revaluation**; HK\$81 million fall in **gains less losses from financial investments and fixed assets** and HK\$59 million drop in **share of profits from associates**, mainly from Industrial Bank.

**Gains less losses from financial investments and fixed assets** amounted to HK\$186 million, a decrease of 30.3 per cent when compared with 2008.

As the Group disposed of most of its equity holdings in 2008, net gains from the disposal of available-for-sale equity securities decreased by HK\$485 million, or 75.1 per cent and impairment charges for certain available-for-sale equity securities amounted to HK\$4 million compared with charges of HK\$284 million in 2008. The net gain on the disposal of assets held for sale increased by HK\$187 million, due mainly to a gain on the disposal of a property.

**Net surplus on property revaluation rose by 177.2 per cent to HK\$219 million.**

*Figures in HK\$m*

	<u>2009</u>	<u>2008</u>
Surplus of revaluation on investment properties	<b>250</b>	8
(Revaluation deficit)/reversal of revaluation deficit on premises	<b>(31)</b>	71
	<u><b>219</b></u>	<u>79</u>

The Group's premises and investment properties were revalued at 30 November 2009 and updated for any material changes at 31 December 2009 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use and the basis of valuation for investment properties was open market value. The net revaluation surplus for Group premises amounted to HK\$669 million of which HK\$700 million was credited to premises revaluation reserve and HK\$31 million was charged to the income statement. Revaluation gains of HK\$250 million on investment properties were recognised through the income statement. The related deferred tax provisions for Group premises and investment properties were HK\$109 million and HK\$41 million respectively.

The revaluation exercise also covered business premises/investment properties reclassified as properties held for sale. In accordance with HKFRS 5, there was no revaluation gain/loss recognised through the income statement.

## Customer Group Performance

The table below sets out the profit before tax contributed by the customer groups for the years stated.

<i>Figures in HK\$m</i>	<i>Personal Financial Services</i>	<i>Commercial Banking</i>	<i>Corporate Banking</i>	<i>Treasury</i>	<i>Other</i>	<i>Total Reportable Segments</i>
<i>Year ended 31 December 2009</i>						
Profit before tax	<u>7,258</u>	<u>2,637</u>	<u>915</u>	<u>3,393</u>	<u>1,274</u>	<u>15,477</u>
Share of profit before tax	<u>46.9%</u>	<u>17.0%</u>	<u>5.9%</u>	<u>21.9%</u>	<u>8.3%</u>	<u>100.0%</u>
<i>Year ended 31 December 2008</i>						
Profit before tax	<u>8,410</u>	<u>2,470</u>	<u>645</u>	<u>2,279</u>	<u>2,074</u>	<u>15,878</u>
Share of profit before tax	<u>52.9%</u>	<u>15.6%</u>	<u>4.1%</u>	<u>14.4%</u>	<u>13.0%</u>	<u>100.0%</u>

**Personal Financial Services ('PFS')** reported a profit before tax of HK\$7,258 million for 2009, 13.7 per cent lower than in 2008. Operating profit excluding loan impairment charges was down 11.9 per cent at HK\$7,457 million. In the second half of 2009, the business experienced a moderate rebound amid steadying economic conditions and improving market sentiment. Profit before tax and operating profit excluding loan impairment charges for the second half of 2009 were up 9.3 per cent and 8.4 per cent respectively compared with the first half.

Despite the excessive liquidity driving down market interest rates, PFS managed to partly offset the effect of compressed deposit spreads and the repricing of the mortgage portfolio by successfully deploying the commercial surplus to achieve growth in the secured and unsecured lending portfolios. Net interest income for the year declined by 5.8 per cent, but increased by 4.1 per cent in the second half compared with the first half.

Total operating income from unsecured lending business recorded year-on-year growth of 16.0 per cent, underpinned by the increase in the number of credit cards in force as well as card spending and receivables. Effective marketing campaigns helped the Bank gain market share and the card base grew by 6.5 per cent to 1.85 million cards in use. Card receivables rose by 7.6 per cent compared with a year earlier to HK\$13.8 billion, outperforming market peers. Personal lending was up 9.3 per cent, with a total loan balance of HK\$3.6 billion.

The Bank's residential mortgage business sustained its market leadership in the active property sector and gained market share despite intense competition. The Bank ranked second for the provision of equitable mortgages in Hong Kong throughout 2009 and, at 31 December 2009, its market share in terms of total mortgage loans stood at 15.1 per cent.

PFS' prudent credit strategy and improvements in unemployment and bankruptcy trends beginning in mid-2009 saw loan impairment charges drop by 34.3 per cent in the second half of the year compared with the first half.

Against the backdrop of new rules governing the physical segregation of banking and investment services, the improving market sentiment in the second half of the year helped support investment business momentum. Securities brokerage business and investment funds business registered a 29.3 per cent and 236.1 per cent increase in turnover in the second half of 2009 compared with the first half of 2009. Although non-interest income fell by 15.4 per cent compared with 2008, growth of 13.5 per cent and 52.7 per cent was achieved in the second half of 2009 compared with the first half of 2009 and the second half of 2008 respectively.

Wealth management income was broadly in line with 2008 at HK\$4,672 million, representing a slight drop of 2.4 per cent.

Sales of wealth management products improved as the effects of financial stimulus policies introduced in Hong Kong started to take effect and help stabilise market conditions. In the very low



interest rate environment, the Bank capitalised on growing investor appetite for lower-risk yield-enhancement opportunities. Turnover of our foreign exchange-linked investment deposits in 2009 exceeded HK\$130 billion – more than triple that recorded in 2008.

Income from life insurance business grew by 46.8 per cent. Diversification of the product range with the launch of new plans that offer improved protection propositions proved effective in driving sales. Total policies in-force and total annualised premiums rose by 10.1 per cent and 14.7 per cent respectively.

Personal e-Banking continued to grow steadily with over 980,000 registered customers at 31 December 2009 – a 12.8 per cent increase compared with the end of 2008. Customers continued to support the Bank's environmental protection efforts with a 54.5 per cent increase in the number of accounts switching to the e-statement service during the year to reach more than 330,000. Hang Seng was among the first banks in Hong Kong to launch a mobile phone-based travel insurance application service and introduce touch screen technology in its network of self-service terminals.

**Commercial Banking ('CMB')** reported a 6.8 per cent increase in profit before tax to reach HK\$2,637 million in the face of challenging market conditions. CMB's contribution to the Bank's total profit before tax increased to 17.0 per cent, up 1.4 percentage points from a year earlier. Operating profit excluding loan impairment charges was down 15.5 per cent at HK\$1,989 million, due mainly to falling deposit spreads in the low interest rate environment. On the back of improving market conditions and a continuing emphasis on vigilant risk management, loan impairment charges fell significantly by 67.4 per cent.

With upturns in economic activity and the property market during the second half of 2009, customer advances rose by 12.1 per cent. Assisted by the establishment of a dedicated deposit service team and the influx of liquidity into the market, customer deposits recorded notable growth of 26.0 per cent. However, the positive impact of this growth in advances and deposits was more than offset by continuing pressure on deposit margins, resulting in a year-on-year decline of 16.6 per cent in net interest income.

CMB continued to develop its corporate wealth management business, enjoying particular success with corporate life insurance products which offered customers diversified insurance solutions, comprehensive protection, customised benefits and flexible payment options. An Executive Retention Insurance Plan for business owners who want to retain key executives with additional benefits was launched towards the end of the year. Income from corporate life insurance recorded impressive growth of 103.1 per cent. Business momentum was sustained in investment services with more defensive investment instruments and treasury hedging solutions that served customers' business needs in the prevailing economic conditions. These initiatives helped mitigate the unfavourable impact of the overall fall in investment activity, with corporate wealth management income recording a small decline of 1.8 per cent. Corporate wealth management income contributed 13.2 per cent to CMB's total operating income in 2009.

In response to the announcement of the pilot Renminbi Trade Settlement Scheme by the Central Government on the Mainland, CMB launched a series of renminbi trade settlement services in July to support the cross-border renminbi trade between Hong Kong companies and designated mainland enterprises in the five pilot cities (Shanghai, Shenzhen, Guangzhou, Dongguan and Zhuhai). This enhanced product suite was further supported by an agreement signed with China Export and Credit Insurance Corporation (SINOSURE) in December, which reinforces CMB's capability to offer one-stop buyer credit protection and accounts receivable financial solutions. Close collaboration with Hang Seng China and the Bank's strategic partners on the Mainland also put CMB in a stronger position to capture a growing share of cross-border business flows.

With strong roots in its local communities, the Bank continued to be an active player in government-backed schemes to support small and medium-sized enterprises facing tough economic times. Since the launch of the SME Loan Guarantee Scheme and Special Loan Guarantee Scheme in late 2008, the Bank has approved over 5,000 applications with a total loan amount of more than HK\$14.2 billion and with market shares in the SME Loan and Special Loan schemes of 33.3 per cent and 15.2 per cent respectively.

CMB customers continued to switch to online and automated banking channels. In December, CMB enhanced its Business e-Banking proposition with the launch of online investment fund trading

services. At 31 December 2009, over 77,000 customers had registered for the Bank's Business e-Banking service, up 19.0 per cent compared with a year earlier. The number of online business transactions grew by 13.3 per cent. Branch counter transactions fell by 14.6 per cent compared with 2008.

**Corporate Banking ('CIB')** capitalised on its in-depth understanding of the market and its customers to support funding needs in a tight credit market, particularly in early 2009. As the economic environment stabilised, more lenders returned to the market, leading to keener competition for loans business. Despite this, CIB managed to maintain good loan asset portfolios – priced in line with conditions in the credit market – both in Hong Kong and on the Mainland, resulting in a 41.5 per cent increase in loan interest income compared with 2008 despite a 5.6 per cent decline in the total loan balance.

Competition for deposits business remained intense throughout the year. In the low interest rate environment, CIB recorded a 40.8 per cent drop in its time deposits balance. However, due to strong customer service relationships and CIB's customer profile, current and savings account deposits increased. The total deposit balance at end of 2009 was down 9.4 per cent compared with a year earlier. Deposit net interest income declined by 36.4 per cent.

Net operating income before loan impairment charges was HK\$1,311 million – a year-on-year increase of 15.3 per cent. With the improved loan assets portfolio, loan impairment charges for both Hong Kong and mainland loan books were lower than in 2008. Net operating income after loan impairment charges was up 31.7 per cent at HK\$1,233 million.

**Treasury ('TRY')** reported relatively stable operating income in 2009, recording a drop of 3.0 per cent. The favourable interest rate environment and ample liquidity in the market enabled TRY to maintain the cost of funds at a relatively low level during the year. However, the low interest rates also limited the yields that could be generated from fund deployment and balance sheet management investments. Net interest income was HK\$2,162 million, down 19.4 per cent compared to 2008.

Net trading income increased substantially by HK\$413 million, or 64.4 per cent, to reach HK\$1,054 million, mainly attributable to a HK\$462 million net increase in funding swap<sup>†</sup> income (described below). For income from sales and trading other than from funding swaps, TRY maintained business momentum by strengthening sales of foreign exchange-linked products to offset weak customer appetite for more sophisticated equity-linked and interest rate-linked structured products.

TRY maintained a prudent risk management strategy, with investment focused mainly on high-quality debt securities, particularly government-guaranteed papers and high-quality corporate securities. The credit quality of the balance sheet management portfolio improved significantly during the year, resulting in a HK\$1,373 million reduction in credit risk provisions compared with 2008. This underpinned the increase of 66.8 per cent, or HK\$1,275 million, in net operating income after credit risk provisions.

TRY captured opportunities in the market during the year to dispose of selected securities to achieve an improved mix of investments in the balance sheet management portfolio. While this action was in line with the Bank's prudent risk management strategy, the accompanying disposal loss of HK\$152 million partly offset growth in net operating income. Profit before tax was up 48.9 per cent at HK\$3,393 million, representing 21.9 per cent of the Bank's total profit before tax.

<sup>†</sup> *Treasury from time to time employs foreign exchange swaps for its funding activities, which in essence involves swapping a currency ('original currency') into another currency ('swap currency') at the spot exchange rate for short-term placement and simultaneously entering into a forward exchange contract to convert the funds back to the original currency on maturity of the placement. In accordance with HKAS39, the exchange difference of the spot and forward contracts is required to be recognised as a foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.*

## Mainland Business

Hang Seng Bank (China) Limited ('Hang Seng China') opened three new outlets on the Mainland in 2009. Including a cross-city sub-branch that opened in Guangdong province under CEPA VI in January 2010, Hang Seng China now operates a network of 37 outlets in Beijing, Shanghai, Guangzhou, Dongguan, Shenzhen, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin, Kunming, and Foshan. The Bank has a branch in Shenzhen for foreign currency wholesale business and a representative office in Xiamen.

Despite the mainland economy displaying good resilience against the effects of the global financial crisis, the economic outlook – particularly in the first half of the year – remained uncertain. Against the backdrop of a large-scale stimulus package implemented in 2009, Hang Seng China recorded notable loan growth in the second half of the year. At 31 December 2009, lending was up 5.2 per cent compared with a year earlier. With the further development of wealth management business and Commercial Banking's growing service capabilities, Hang Seng China's customer base recorded solid growth of 18.3 per cent when compared with the end of 2008, including a 25.2 per cent increase in the total number of Prestige Banking customers. These increases helped underpin a 35.9 per cent rise in the deposit base. Total operating income increased by 3.9 per cent, benefiting from the 1.3 per cent growth in net interest income. Reduced exchange losses from the revaluation of US dollar capital funds against the renminbi were partly offset by the reduction in other operating income during the year.

Hang Seng China continued to further enrich and diversify its product offerings to cater for different market conditions and to promote wealth management awareness among target customer segments. Hang Seng China has also signed an agreement with China Export and Credit Insurance Corporation (SINOSURE) that will enhance its cross-border service proposition for commercial customers.

Hang Seng China is striving to improve its network and business development efficiency by increasing its penetration in four key cities: Shanghai, Shenzhen, Guangzhou and Beijing. Resources are also being redeployed to achieve greater management and operational efficiency. Management of credit risk and operational risk continues to be strengthened through proactive risk management practices.

The Bank remains firmly committed to developing its mainland business, through both Hang Seng China and long-term relationships with mainland partners. The Bank's strategic alliance with Industrial Bank Co., Ltd. ('Industrial Bank') reached its fifth anniversary in April 2009 and continues to yield good results. Including the Bank's share of profit from Industrial Bank and Yantai Bank Co., Ltd. ('Yantai Bank'), mainland business contributed 13.3 per cent of total profit before tax, compared with 11.9 per cent in 2008.

## Economic Profit

Economic profit is calculated from post-tax profit, adjusted for any surplus/deficit arising from property revaluation, depreciation attributable to the revaluation surplus and impairment of purchased goodwill and takes into account the cost of capital invested by the Bank's shareholders.

For the year 2009, economic profit was HK\$8,372 million, a decrease of HK\$432 million, or 4.9 per cent, compared with 2008. Return on invested capital (post-tax profit, adjusted for the property revaluation surplus net of deferred tax, depreciation attributable to the revaluation and impairment of purchased goodwill), fell by HK\$971 million.

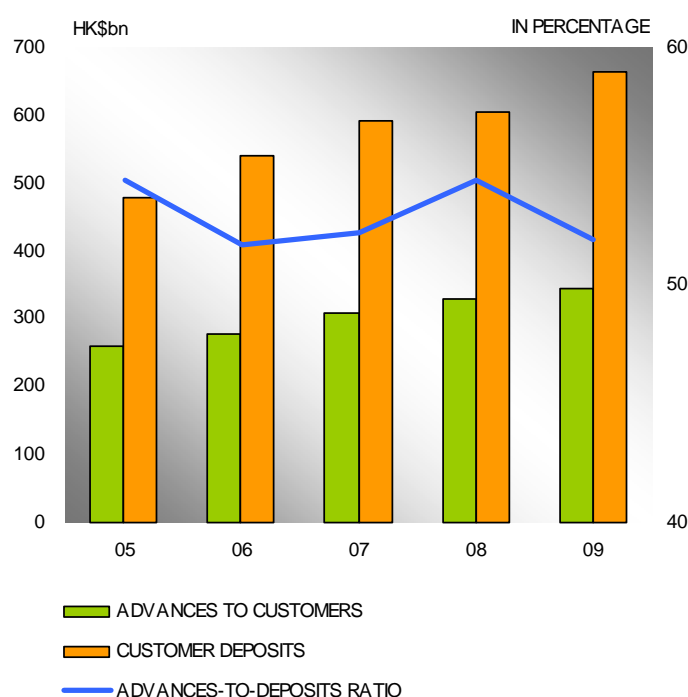
	<b>2009</b>		<b>2008</b>	
	<b>HK\$m</b>	<b>%</b>	<b>HK\$m</b>	<b>%</b>
Average invested capital	<u>53,071</u>		<u>53,866</u>	
Return on invested capital <sup>†</sup>	<b>13,149</b>	<b>24.8</b>	14,120	26.2
Cost of capital	<u>(4,777)</u>	<u>(9.0)</u>	<u>(5,316)</u>	<u>(9.9)</u>
Economic profit	<u><b>8,372</b></u>	<u><b>15.8</b></u>	<u>8,804</u>	<u>16.3</u>

† Return on invested capital is based on post-tax profit excluding any surplus/deficit arising from property revaluation, depreciation attributable to the revaluation surplus and impairment of purchased goodwill.

## Statement of Financial Position

**Total assets** increased by HK\$63.8 billion, or 8.4 per cent, to HK\$826.0 billion. In light of the weak global economy and the fact that financial markets were still recovering from the credit crisis, Treasury continued to take a highly prudent approach in managing its balance sheet management investments. Surplus funds arising from trading assets that matured in 2009 were redeployed to interbank placements and appropriate available-for-sale debt securities to attain yield enhancement. As a result, financial investments – primarily high-quality debt securities which included government-guaranteed debt securities – rose by 33.3 per cent. Customer advances recorded encouraging growth of 4.7 per cent. Despite intense market competition, the Group was able to sustain a leading position and maintained its growth momentum in residential mortgage lending and other personal lending. Mainland lending grew moderately with Hang Seng China continuing to emphasise lending quality over business expansion. Customer deposits and certificates of deposit and other debt securities in issue rose by HK\$59.2 billion, or 9.8 per cent, to HK\$663.7 billion, reflecting customers' lukewarm attitude towards investment and preference for liquidity in the uncertain market conditions. At 31 December 2009, the advances-to-deposits ratio was 51.9 per cent, compared with 54.4 per cent at the end of 2008.

### ADVANCES TO CUSTOMERS AND CUSTOMER DEPOSITS



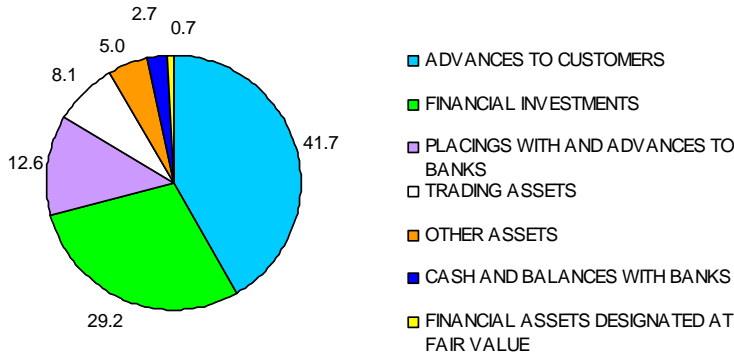
### Assets deployment

Figures in HK\$m

	2009	%	2008	%
Cash and balances with banks and other financial institutions	22,086	2.7	24,822	3.3
Placings with and advances to banks and other financial institutions	104,551	12.6	69,579	9.1
Trading assets	66,597	8.1	108,389	14.2
Financial assets designated at fair value	5,450	0.7	7,798	1.0
Advances to customers	344,621	41.7	329,121	43.2
Financial investments	241,502	29.2	181,159	23.8
Other assets	41,161	5.0	41,300	5.4
<b>Total assets</b>	<b>825,968</b>	<b>100.0</b>	<b>762,168</b>	<b>100.0</b>

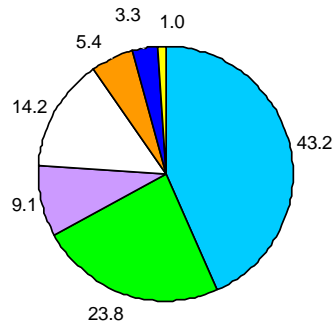
## ASSETS DEPLOYMENT FOR 2009

IN PERCENTAGE



## ASSETS DEPLOYMENT FOR 2008

IN PERCENTAGE



### Advances to customers

At 31 December 2009, gross advances to customers were up HK\$15.4 billion, or 4.7 per cent, at HK\$346.6 billion compared with the previous year-end.

Loans for use in Hong Kong increased by HK\$14.9 billion, or 5.4 per cent. New financing for corporate customers was active, reflecting strong growth in property investment lending in line with the buoyant property market. Following the Hong Kong Government's launch of two government-guaranteed lending schemes – the SME Loan Guarantee Scheme ('SGS') and the Special Loan Guarantee Scheme ('SpGS') – to facilitate financial institutions in supporting SMEs in challenging credit conditions, the Bank has actively promoted these schemes to its existing clientele and potential new customers. This boosted lending to the wholesale and retail trade sector. The decline in lending to manufacturing sector was mainly due to a large loan repayment during the year. Growth in lending to the 'Other' sector was due to the increase in new financing to certain large corporate customers.

Lending to individuals increased slightly by HK\$5.9 billion, or 4.5 per cent. Excluding the fall in Government Home Ownership Scheme ('GHOS') mortgages, lending to individuals grew by 7.0 per cent. Despite intense competition, the Bank was able to sustain a leading position in the mortgage market by offering comprehensive mortgage consultancy and e-mortgage services to capitalise on new business opportunities in the booming property market and the low interest rate environment. Riding on this momentum, residential mortgage lending to individuals grew by a remarkable 7.8 per cent. Sustained strong customer spending saw card advances increase by 7.6 per cent. The Bank gained market share during the year, supported by a 6.5 per cent rise in the number of cards in issue and a 9.1 per cent increase in cardholder spending. Loans to other individuals remained broadly the same as in 2008.

Despite the contraction in global trade activity, trade finance was able to achieve modest growth against 2008 year-end, reflecting the Bank's success in broadening its range of product and service offerings for SME customers in Hong Kong, the Mainland and Macau.

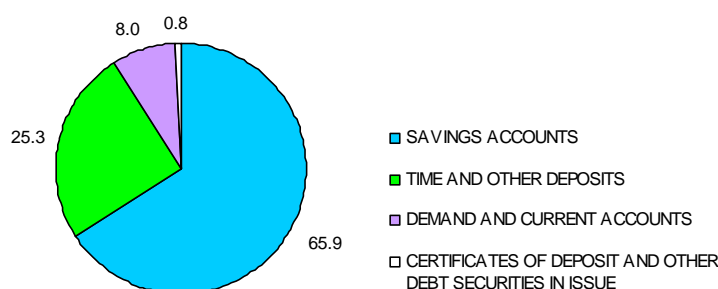
Loans for use outside Hong Kong grew by 1.0 per cent. This was due largely to the 5.2 per cent expansion in the Mainland loan portfolio, which had reached HK\$28.3 billion at 31 December 2009. In the uncertain credit environment, the Group took a prudent approach in extending its lending business on the Mainland.

## Customer deposits

Customer deposits and certificates of deposit and other debt securities in issue stood at HK\$663.7 billion at 31 December 2009, a rise of 9.8 per cent over the end of 2008. Higher growth was recorded in savings and current account balances, reflecting customer preference for liquidity in the prevailing low interest rate. Structured deposits and other structured certificates of deposits and other debt securities in issue fell, due primarily to reduced demand for such products in the uncertain investment environment. Deposits with Hang Seng (China) Limited rose significantly by 35.9 per cent.

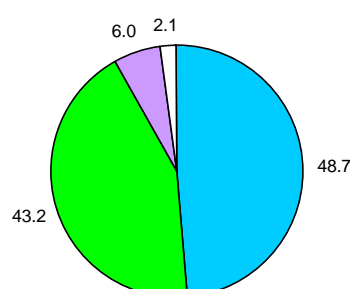
**CUSTOMER DEPOSITS FOR 2009**

IN PERCENTAGE



**CUSTOMER DEPOSITS FOR 2008**

IN PERCENTAGE



## Subordinated liabilities

There was no subordinated debt issued during 2009. The outstanding subordinated notes, which qualify as supplementary capital, serve to help the Bank maintain a more balanced capital structure and support business growth.

## Shareholders' funds

Figures in HK\$m

	<u>2009</u>	<u>2008</u>
Share capital	<b>9,559</b>	9,559
Retained profits	<b>37,719</b>	32,518
Premises revaluation reserve	<b>3,994</b>	3,711
Cash flow hedges reserve	<b>174</b>	562
Available-for-sale investments reserve		
- on debt securities	<b>(496)</b>	(4,137)
- on equity securities	<b>239</b>	314
Capital redemption reserve	<b>99</b>	99
Other reserves	<b>3,303</b>	3,264
Total reserves	<b>45,032</b>	36,331
	<b>54,591</b>	45,890
Proposed dividends	<b>3,633</b>	5,736
Shareholders' funds	<b>58,224</b>	51,626
	<b>24.6%</b>	26.0%
Return on average shareholders' funds		

Shareholders' funds (excluding proposed dividends) grew by HK\$8,701 million, or 19.0 per cent, to reach HK\$54,591 million at 31 December 2009. Retained profits rose by HK\$5,201 million, mainly reflecting the growth in 2009 profit after the appropriation of interim dividends and the increase in actuarial gains on the defined benefit scheme. Against the backdrop of the rebound in the property market during the year, the premises revaluation reserve increased by HK\$283 million compared with 2008.

In accordance with accounting standards, available-for-sale debt and equity securities should be measured at fair value. The carrying amounts of the various debt and equity securities are reviewed at the end of the reporting period to determine whether there is any objective evidence of impairment. If evidence exists, the relevant carrying amount is reduced to the estimated recoverable amount by means of an impairment charge to the income statement.

The available-for-sale investments reserve for debt securities showed a deficit of HK\$496 million compared with a deficit of HK\$4,137 million at 2008 year-end, reflecting the improvement and stabilisation in global credit markets and the disposal of high-risk assets under the Bank's prudent risk management strategy. The Group assessed that there were no impaired debt securities during the year, and accordingly, no impairment loss has been recognised.

The return on average shareholders' funds was 24.6 per cent, compared with 26.0 per cent for 2008.

There was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities in 2009.

## RISK MANAGEMENT

The effectiveness of the Group's risk management policies and strategies is a key success factor. Operating in the financial services industry, the most important types of risks the Group is exposed to are credit, liquidity, market, legal, operational, reputational and strategic. The Group has established policies and procedures to identify and analyse risks and to set appropriate risk limits to control this broad spectrum of risks. To further enhance the Bank's risk management framework and in line with best practices, the Bank has set up a Risk Management Committee to centralise the risk management oversight function of the Bank. The Risk Management Committee is constituted by the Board but reports to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank and is responsible for approval of all risk management related policies and major control limits. Risk limits are monitored and controlled continually by dedicated departments by means of reliable and up-to-date management information systems. The management of various types of risks is well coordinated at the level of the Bank's Board and various Management committees, such as, the Executive Committee, Risk Management Committee, Asset and Liability Management Committee and Credit Committee.

Note 62 "Financial risk management" to the financial statements provides a detailed discussion and analysis of the Group's credit risk, liquidity risk, market risk, insurance risk, operational risk and capital management. The management of reputational risk is set out as follows:

Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events. Standards are set and policies and procedures are established in all areas of reputational risk and are communicated to staff at all levels. These include fair and transparent dealings with customers, conflicts of interest, money laundering deterrence, environmental impact and anti-corruption measures. The reputational downside to the Group is fully appraised before any strategic decision is taken.

The Group is a socially and environmental responsible organization. Its corporate social responsibility policies and practices are discussed in the corporate responsibility section of this annual report.



## BIOGRAPHICAL DETAILS OF DIRECTORS

\* **Dr Raymond CH'IEN Kuo Fung** GBS, CBE, JP  
Chairman

*Aged 58*

*Joined the Board since August 2007*

### *Other major appointments*

- ^ **CDC Corporation** – Chairman
- ^ **CDC Software Corporation** – Director (*Note 1*)
- ^ **China.com Inc** – Chairman
- ^ **Convenience Retail Asia Limited** – INED
- Federation of Hong Kong Industries** – Honorary President
- Hong Kong Mercantile Exchange Limited** – INED (*Note 1*)
- HSBC Private Equity (Asia) Limited** – Chairman
- ^ **MTR Corporation Limited** – Non-executive Chairman
- ^ **Swiss Reinsurance Company Limited** – INED
- The Hongkong and Shanghai Banking Corporation Limited** – INED
- The Hong Kong/European Union Business Cooperation Committee** – Chairman
- The Tianjin Municipal Committee of the Chinese People's Political Consultative Conference** – Member of Standing Committee
- ^ **The Wharf (Holdings) Limited** – INED
- University of Pennsylvania, USA** – Trustee

### *Past major appointments*

- The APEC Business Advisory Council** – Hong Kong Member (2004 – 2009) (*Note 1*)
- ^ **Inchcape plc** – INED (1997 – 2009)
- ^ **HSBC Holdings plc** – INED (1998 – 2007)
- Independent Commission Against Corruption** – Chairman of Advisory Committee on Corruption (1998 – 2006)
- Executive Council of HKSAR Government** – Member (1997– 2002)
- Executive Council of Hong Kong, then under British Administration** – Member (1992 – 1997)

### *Qualification*

Doctoral Degree in Economics – University of Pennsylvania, USA

### *Major awards*

Chevalier de l'Ordre du Merite Agricole of France (2008)  
Gold Bauhinia Star (1999)  
Commander in the Most Excellent Order of the British Empire (1994)  
Justice of the Peace (1993)

**Mrs Margaret LEUNG KO May Yee** JP  
Vice-Chairman and Chief Executive

*Aged 57*

*Joined the Board since April 2009*

### *Other positions held within Hang Seng Group*

**Hang Seng Bank Limited** – Chairman of Executive Committee  
**Hang Seng Bank (China) Limited** – Chairman  
**Hang Seng Indexes Company Limited** – Chairman of Hang Seng Index Advisory Committee (*Note 1*)  
**Hang Seng Insurance Company Limited** – Chairman  
Chairman of other subsidiaries in Hang Seng Group

Other major appointments

- Hang Seng School of Commerce** – Chairman of the Board; Supervisor  
**HKSAR Commission on Strategic Development** – Member  
**Ho Leung Ho Lee Foundation** – Member of Board of Trustees  
**Hong Kong Baptist University** – Member of the Court  
**Hong Kong Export Credit Insurance Corporation** – Member of Advisory Board  
**Hong Kong University Alumni Association** – Honorary Vice-President (*Note 1*)  
^ **HSBC Holdings plc** – Group General Manager  
^ **Hutchison Whampoa Limited** – INED  
**Securities and Futures Commission** – Member of Advisory Committee  
^ **Swire Pacific Limited** – INED  
**The Community Chest of Hong Kong** – Board Member; Second Vice President; Chairman of 2009 – 2010 Campaign Committee  
**The Guangzhou Municipal Committee of the Chinese People’s Political Consultative Conference** – Member  
**The Henan Provincial Committee of the Chinese People’s Political Consultative Conference** – Member of Standing Committee  
**The Hongkong and Shanghai Banking Corporation Limited** – Director  
**The University of Hong Kong** – Member of the Council (*Note 1*)

Past major appointments

- Wells Fargo HSBC Trade Bank, NA** – Director (2007 – February 2010) (*Note 1*)  
**HSBC Group** – Global Co-Head Commercial Banking (2003 – 2009)

Qualification

Bachelor’s Degree in Economics, Accounting and Business Administration – The University of Hong Kong

Major award

Justice of the Peace (2009)

- \* **Dr John CHAN Cho Chak** GBS, JP  
Director

Aged 66

Joined the Board since August 1995

Other position held within Hang Seng Group

**Hang Seng Bank Limited** – Chairman of Remuneration Committee

Other major appointments

- ^ **Guangdong Investment Ltd** – INED  
**Long Win Bus Company Limited** – NED  
^ **RoadShow Holdings Ltd** – Chairman and NED  
**Sir Edward Youde Memorial Fund** – Chairman of the Council  
**The Community Chest of Hong Kong** – Vice Patron  
**The Hong Kong Jockey Club** – Chairman  
**The Hong Kong Monetary Authority** – Member of The Exchange Fund Advisory Committee  
**The Hong Kong University of Science and Technology** – Chairman of the Court  
**The Kowloon Motor Bus Company (1933) Ltd** – NED  
^ **Transport International Holdings Limited** – NED

Past major appointments

- HKSAR Commission on Strategic Development** – Non-Official Member (2005 – 2009)  
^ **Hong Kong Exchanges and Clearing Limited** – INED (2000 – 2003)  
**Hong Kong Civil Service** – Private Secretary to the Governor; Deputy Secretary (General Duties); Director of Information Services; Deputy Chief Secretary; Secretary for Trade and Industry; Secretary for Education and Manpower (1964 – 1978; 1980 – 1993)

Qualifications

Degree of Doctor of Social Sciences (honoris causa) – The Hong Kong University of Science and Technology

Degree of Doctor of Business Administration (honoris causa) – International Management Centres

Diploma in Management Studies – The University of Hong Kong

Honours Degree in English Literature – The University of Hong Kong

Major awards

Gold Bauhinia Star (1999)

Justice of the Peace (1994)

- \* **Dr Marvin CHEUNG Kin Tung** DBA(Hon), GBS, SBS, OBE, JP  
Director

Aged 62

Joined the Board since May 2004

Other position held within Hang Seng Group

**Hang Seng Bank Limited** – Member of Audit Committee

Other major appointments

**Airport Authority Hong Kong** – Chairman

**Barristers Disciplinary Tribunal** – Member

**Executive Council of HKSAR Government** – Non-official Member

- ^ **HKR International Limited** – INED

- ^ **Hong Kong Exchanges and Clearing Limited** – INED

**Hong Kong University of Science and Technology** – Chairman of the Council

- ^ **HSBC Holdings plc** – INED; Audit Committee member (*Note 1*)

**The Tracker Fund of Hong Kong** – Chairman of the Supervisory Committee

Past major appointments

- ^ **Sun Hung Kai Properties Limited** – INED (2007 – 2009) (*Note 1*)

**Independent Commission Against Corruption** – Member of Operations Review Committee  
(2004 – 2009) (*Note 1*)

**KPMG Hong Kong** – Chairman and Chief Executive Officer (1996 – 2003)

Qualifications

Fellow – Hong Kong Institute of Certified Public Accountants

Fellow – Institute of Chartered Accountants in England and Wales

Doctor of Business Administration (Honours) – Hong Kong Baptist University

Major awards

Gold Bauhinia Star (2008)

Silver Bauhinia Star (2000)

Officer of the Order of the British Empire (1993)

Justice of the Peace (1991)

- # **Mr Alexander Andrew FLOCKHART** CBE  
Director

Aged 58

Joined the Board since August 2007

Other major appointments

- ^ **HSBC Holdings plc** – Executive Director; member of Group Management Board; Chairman, Personal and Commercial Banking and Insurance (*Note 1*)

**The Hongkong and Shanghai Banking Corporation Limited** – Executive Director

**HSBC Latin America Holdings (UK) Limited** – Chairman (*Note 1*)

**HSBC Bank Australia Limited** – Director  
**Visa Inc** – Member of Visa Asia Pacific Senior Advisory Council  
**Chongqing Mayor's International Economic Advisory Council** – Member

Past major appointments

**HSBC Bank (China) Company Limited** – NED (2007 – February 2010) (Note 1)

**The Hongkong and Shanghai Banking Corporation Limited** – Chief Executive Officer (2007 – January 2010) (Note 1)

**HSBC Group** – Global Head of Commercial Banking (2007 – January 2010) (Note 1)

^ **HSBC Holdings plc** – Group Managing Director Asia-Pacific (2006 – 2008)

Joined HSBC Group in 1974, and had been posted to various senior positions in Latin America, Mexico, USA, Saudi Arabia, Thailand, Hong Kong, the United Arab Emirates and Qatar.

Qualification

Degree in Law (LLB) – Edinburgh University

Major award

Commander of the British Empire (2007)

\* **Mr Jenkin HUI**

Director

Aged 66

Joined the Board since August 1994

Other position held within Hang Seng Group

**Hang Seng Bank Limited** – Member of Remuneration Committee

Other major appointments

**Central Development Ltd** – Director

**Hongkong Land Holdings Ltd** – Director

**Jardine Matheson Holdings Ltd** – Director

**Jardine Strategic Holdings Ltd** – Director

**Point Piper Investment Ltd** – Chief Executive

**Mr William LEUNG Wing Cheung** BBS, JP

Executive Director and Head of Personal Banking

Aged 55

Joined the Board since August 2009

Other positions held within Hang Seng Group

**Hang Seng Bank Limited** – Head of Personal Banking (responsible for the Bank's branch network and all businesses and services for personal accounts); member of Executive Committee

**Hang Seng General Insurance (Hong Kong) Company Limited** – Chairman

**Hang Seng Insurance Company Limited** – Director

Chairman or Director of other subsidiaries in Hang Seng Group

Other major appointments

**EPS Company (Hong Kong) Limited** – Director

**Hang Seng School of Commerce** – Director

**Hong Kong Academy for Performing Arts** – Chairman of the Council (Note 1)

**Hong Kong Baptist University** – Treasurer of the Council and the Court; Chairman of Finance Committee and Honorary Associate of School of Business

**Hong Kong Creative Arts Centre Limited** – Chairman

**HSBC Global Asset Management (Hong Kong) Limited** – Director

^ **Industrial Bank Co Ltd** – Member of Management Committee of Credit Card Centre

**MasterCard Asia/Pacific, Middle East & Africa Regional Advisory Board** – Director (Note 1)

**Securities and Futures Commission** – Member of Investor Education Advisory Committee

**TransUnion Limited** – Director

**West Kowloon Cultural District Authority** – Member of Consultation Panel  
**Yantai Bank Co Ltd** – Director

Past major appointments

**Hang Seng Bank Limited**

General Manager, Personal Financial Services and Wealth Management (2005 – 2009)  
General Manager and Head of Wealth Management (2005)  
Deputy General Manager and Deputy Head of Commercial Banking (2003 – 2005)  
Deputy General Manager and Deputy Head of Retail Banking (2000 – 2003)  
Assistant General Manager and Head of Credit Card Centre (1994 – 2000)

Qualification

Diploma of Arts in English Language and Literature – Hong Kong Baptist College

Major awards

Bronze Bauhinia Star (2009)  
Justice of the Peace (2005)

\* **Dr Eric LI Ka Cheung** FCPA (Practising), GBS, OBE, JP  
Director

Aged 56

Joined the Board since February 2000

Other position held within Hang Seng Group

**Hang Seng Bank Limited** – Chairman of Audit Committee

Other major appointments

- ^ **Bank of Communications Co Ltd** – INED; Chairman of Audit Committee
- ^ **China Resources Enterprise Ltd** – INED
- HKSAR Commission on Strategic Development** – Member
- Hong Kong Monetary Authority** – Chairman of Process Review Committee
- Li, Tang, Chen & Co, Certified Public Accountants** – Senior Partner
- Long Win Bus Company Limited** – INED
- ^ **Meadville Holdings Limited** – INED
- ^ **RoadShow Holdings Ltd** – INED
- ^ **SmarTone Telecommunications Holdings Ltd** – INED
- ^ **Sun Hung Kai Properties Limited** – INED
- The Financial Reporting Council** – Convenor of Financial Reporting Review Committee
- The Hong Kong Institute of Education** – Treasurer of the Council
- The Kowloon Motor Bus Co (1933) Ltd** – INED
- The Eleventh National Committee of Chinese People's Political Consultative Conference** – Member
- ^ **Transport International Holdings Limited** – INED
- ^ **Wong's International (Holdings) Ltd** – INED

Past major appointments

- ^ **Sinofert Holdings Limited** – INED (resigned in 2007)
- ^ **CATIC International Holdings Limited** – INED (resigned in 2007)
- Hong Kong Society of Accountants** – President (1994)

Qualifications

BA (Economics) Honours Degree – University of Manchester, UK  
Fellow – Hong Kong Institute of Certified Public Accountants (Practising)  
Hon Doctor of Laws – University of Manchester, UK  
Hon Doctor of Social Sciences – Hong Kong Baptist University

Major awards

Gold Bauhinia Star (2003)  
Most Excellent Order of the British Empire (1996)  
Justice of the Peace (1991)

# **Dr Vincent LO Hong Sui** GBS, JP

Director

*Aged* 61

*Joined the Board since* February 1999

*Other major appointments*

**Business and Professionals Federation of Hong Kong** – Honorary Life President

**Chongqing Municipal Government** – Economic Adviser

^ **Great Eagle Holdings Ltd** – NED

**Shanghai-Hong Kong Council for the Promotion and Development of Yangtze** – President

**Shanghai Tongji University; Shanghai University** – Advisory Professorship

^ **Shui On Construction and Materials Limited** – Chairman

**Shui On Group** – Chairman

^ **Shui On Land Ltd** – Chairman and Chief Executive Officer

**The Eleventh National Committee of the Chinese People's Political Consultative Conference** – Member

**The Hong Kong University of Science and Technology** – Honorary Court Chairman

*Past major appointment*

^ **China Telecom Corporation Limited** – INED (retired in 2008)

*Qualification*

Doctorate in Business Administration (honoris causa) – The Hong Kong University of Science and Technology

*Major awards*

“Ernst & Young Entrepreneur Of The Year 2009” in the China Real Estate Category (2009)

“Ernst & Young Entrepreneur Of The Year 2009 China” country award winner (2009)

Chevalier des Arts et des Lettres by the French Government (2005)

Director of the Year in the category of Listed Company Executive Directors by The Hong Kong Institute of Directors in 2002 (2002)

Businessman of the Year award in the Hong Kong Business Awards 2001 (2001)

Justice of the Peace (1999)

Gold Bauhinia Star (1998)

# **Mr Iain James MACKAY**

Director

*Aged* 48

*Joined the Board since* September 2009

*Other major appointments*

**Pathways Foundation Limited** (Note 1) – Executive Councillor; Honorary Treasurer; Chairman of Finance Committee

**The Hongkong and Shanghai Banking Corporation Limited** – Chief Financial Officer; Director of various HSBC Group subsidiaries

**WWF Hong Kong** (Note 1) – Trustee member; member of Executive Council; Honorary Treasurer

*Past major appointments*

**HSBC North America Holdings Inc** – Senior Executive Vice President and Chief Financial Officer (2007 – 2009)

**Aberdeen University Development Trust** – Director (2007 – 2009)

**GE Healthcare Technologies** – Corporate Vice President and Chief Financial Officer for the Global Diagnostic Imaging Business (2004 – 2007) (before then held various senior positions in the GE Group including GE Consumer Finance, GE Equity and GE Capital)

Qualifications

Master's Degree in Business Studies (Accounting primary) – Aberdeen University of Scotland  
Member – Institute of Chartered Accountants of Scotland

# **Mrs Dorothy SIT KWAN Yin Ping**

Director

Aged 58

Joined the Board since August 2009

Other position held within Hang Seng Group

**Hang Seng Bank (China) Limited** – Vice Chairman; Chief Executive; Chairman of Executive Committee

Past major appointments

**The Banking Industry Training Advisory Committee** – Member (2006 – 2009); Ex-officio Member of its Sub-committee on Specification of Competency Standards Development (2007 – 2009)

**Hang Seng Bank Limited** – General Manager (2005 – 2009); Chief Operating Officer (2006 – 2009)

**The Hongkong and Shanghai Banking Corporation Limited** – Joined as management trainee and held various managerial positions in retail banking, operations and systems, mainland China project finance, internal audit, marketing, channel development and management, wealth management and retail investments (1976 – 2003) and was Head of Personal Financial Services, Hong Kong (2004 – 2005)

**Bank of Shanghai** – Director (2004 – 2005)

Qualification

Master's Degree in Business Administration – The Chinese University of Hong Kong

\* **Mr Richard TANG Yat Sun** MBA, BBS, JP

Director

Aged 57

Joined the Board since August 1995

Other positions held within Hang Seng Group

**Hang Seng Bank Limited** – Member of Audit Committee

**Hang Seng Bank (China) Limited** – Supervisor

Other major appointments

**Correctional Services Children's Education Trust Investment Advisory Board** – Chairman

**Customs and Excise Service Children's Education Trust Fund Committee** – Chairman

**Hong Kong Commercial Broadcasting Co Ltd** – Director

**Hong Kong Institute of Certified Public Accountants** – Member of Disciplinary Panel A

^ **King Fook Holdings Ltd** – Vice Chairman

^ **Miramar Hotel & Investment Co Ltd** – Director

**Richcom Co Ltd** – Chairman and Managing Director

**Tang Shiu Kin and Ho Tim Charitable Fund** – Member

Qualifications

Bachelor of Science Degree in Business Administration – Menlo College, California, USA

Master's Degree in Business Administration – University of Santa Clara, California, USA

Major awards

Bronze Bauhinia Star (2000)

Justice of the Peace (1997)

# **Mr Peter WONG Tung Shun JP**

Director

*Aged 58*

*Joined the Board since May 2005*

*Other major appointments*

- ^ **Bank of Communications Co Ltd** – NED
- ^ **Cathay Pacific Airways Limited** – INED
- Greater Pearl River Delta Business Council** – Member
- ^ **Hong Kong Exchanges and Clearing Limited** – Member of Risk Management Committee (*Note 1*)
- Hong Kong General Chamber of Commerce** – Director; member of General Committee
- Hong Kong Monetary Authority** – Member of Banking Advisory Committee; member of Exchange Fund Advisory Committee (*Note 1*)
- Hong Kong Trade Development Council** – Chairman of Financial Services Advisory Committee
- HSBC Bank Australia Limited** – NED (*Note 1*)
- HSBC Bank (China) Company Limited** – Deputy Chairman and NED
- ^ **HSBC Holdings plc** (*Note 1*) – Group Managing Director; member of Group Management Board
- ^ **Ping An Insurance (Group) Company of China, Ltd** – NED
- The Hongkong and Shanghai Banking Corporation Limited** – Chief Executive Officer (*Note 1*); Executive Director; Chairman or Director of its subsidiaries, including rural banks incorporated in mainland China
- The Hong Kong Institute of Bankers** – President
- The Tenth Hubei Provincial Committee of the Chinese People’s Political Consultative Conference** – Member

*Past major appointment*

**The Hong Kong Association of Banks** – Chairman (2009) (*Note 1*)

*Qualifications*

Bachelor’s Degree in Computer Science; MBA in Marketing and Finance; MSc in Computer Science – Indiana University, USA

*Major award*

Justice of the Peace (2002)

\* Independent Non-executive Directors (“INED”)

# Non-executive Directors (“NED”)

^ The securities of these companies are listed on a securities market in Hong Kong or overseas.

Notes:

- 1 New appointments or cessation of appointments since the date of the Bank’s 2009 Interim Report or (as the case may be) the date(s) of announcement(s) for the appointment of Directors(s) issued by the Bank subsequent to the date of the Bank’s 2009 Interim Report.
- 2 The interests of Directors in shares of the Bank, if any, within the meaning of Part XV of the Securities and Futures Ordinance (“SFO”) as at 31 December 2009 are disclosed in the section “Directors’ and Alternate Chief Executives’ Interests” of the Report of the Directors attached to the Bank’s 2009 Annual Report.
- 3 Some Directors (as disclosed in the section “Biographical Details of Directors” of the Bank’s 2009 Annual Report) are also Directors of HSBC Holdings plc (“HSBC”) and/or its subsidiaries. HSBC, via its wholly owned subsidiaries, has an interest in the shares of the Bank under the provisions of Divisions 2 and 3 of Part XV of the SFO, the details of which are disclosed in the section “Substantial Interests in Share Capital” of the Report of the Directors attached to the Bank’s 2009 Annual Report.
- 4 Save as disclosed in the section “Biographical Details of Directors” of the Bank’s 2009 Annual Report, the Directors (a) have not held any directorships in other publicly listed companies, whether in Hong Kong or overseas, during the last 3 years; (b) do not hold any other positions in the Bank and its subsidiaries; and (c) do not have any other relationships with any Directors, senior management or substantial or controlling shareholders of the Bank.



- 5 All Directors (except those Directors who are full time employees of the Bank or its subsidiaries) will receive Directors' fees in the amounts approved from time to time by shareholders at the Annual General Meetings of the Bank. The current amounts of Directors' fees have been determined with reference to market rates, directors' workload and required commitment. A Director will also receive a fee for duties assigned to and services provided by him as Chairman or member of various Committees of the Bank. The current amounts of the above fees have been determined with reference to the remuneration policy of the Bank.
- 6 Commencing from 1 January 2008, no Directors' fees will be paid to those Directors who are full time employees of the Bank or its subsidiaries. The salary packages of such Directors have been determined with reference to the remuneration policy of the Bank. Such Directors are also entitled to discretionary bonus.
- 7 The details of the emoluments of the Directors on a named basis are disclosed in Note 19 of the Bank's Financial Statements as contained in the Bank's 2009 Annual Report.
- 8 None of the Directors, except Mr William W Leung has signed service contracts with the Bank. However, the Bank's Articles of Association provide that each Director is required to retire by rotation once every 3 years and that one-third (or the number nearest to one-third) of the Directors shall retire from office every year at the Bank's Annual General Meeting. A Director's specific term of appointment, therefore, cannot exceed 3 years. Every retiring Director shall be eligible for re-election at the Annual General Meeting of the Bank.

## BIOGRAPHICAL DETAILS OF SENIOR MANAGEMENT

### **Mrs Margaret LEUNG KO May Yee JP**

Vice-Chairman and Chief Executive

(Biographical details are set out on pages 55 and 56)

### **Mr William LEUNG Wing Cheung BBS, JP**

Executive Director and Head of Personal Banking

(Biographical details are set out on pages 58 and 59)

### **Mr Andrew FUNG Hau Chung**

General Manager and Head of Treasury and Investment

*Aged 52*

*Joined the Bank since May 2006*

*Major positions held within Hang Seng Group*

**Hang Seng Bank Limited** – General Manager and Head of Treasury and Investment; member of Executive Committee

**Hang Seng Insurance Company Limited** – Director

**Hang Seng Investment Management Limited** – Director and General Manager

*Other major appointments*

**Business Facilitation Advisory Committee** – Non-official member

**Federation of Hong Kong Industries** – Member of General Committee

**Industrial Bank Co Ltd** – Director; member of Executive Committee; member of Remuneration and Examination Committee

**Securities and Futures Commission** – Member of Process Review Panel

*Past major positions*

**Hang Seng Bank Limited**

General Manager and Head of Investment and Insurance (2008 – 2009)

Deputy General Manager and Head of investment and Insurance (2006 – 2008)

**DBS Bank Limited** – Managing Director, Advisory Sales, Greater China, Wholesale Banking – Global Financial Markets (2002 – 2006)

*Qualification*

Bachelor of Arts Degree – The University of Hong Kong

### **Mr NG Yuen Tin**

Deputy General Manager and Head of Corporate Banking

*Aged 58*

*Joined the Bank since July 1971*

*Major positions held within Hang Seng Group*

**Hang Seng Bank Limited** – Deputy General Manager and Head of Corporate Banking

**Hang Seng Finance Limited** – Director and Chief Executive

**Hang Seng Indexes Company Limited** – Director

**HSI International Limited** – Director

*Other major appointment*

**The Hong Kong Institute of Bankers** – Member of Executive Committee

Past major positions

**Hang Seng Bank Limited**

Assistant General Manager and Head of Corporate and Institutional Banking Division (1999 – 2000)

Assistant General Manager and Deputy Head of Corporate Banking Division (1994 –1999)

Qualification

Fellow – The Hong Kong Institute of Bankers

**Mr David TAM Wai Hung**

Deputy General Manager and Chief Risk Officer

Aged 60

Joined the Bank since March 1999

Major positions held within Hang Seng Group

**Hang Seng Bank Limited** – Deputy General Manager and Chief Risk Officer; member of Executive Committee

Other major appointments

**Business and Professionals Federation of Hong Kong** – Vice-Chairman of Executive Committee

**Hong Kong St John Ambulance** – Council Member & Chairman of Finance Committee

**ReSource The Counselling Centre Limited** – Chairman of the Council

Past major positions

**Hang Seng Bank Limited**

Deputy General Manager and Head of Commercial Banking, Greater China (2007 – 2008)

Deputy General Manager and Head of Commercial Banking (2003 – 2006)

Assistant General Manager and Head of Commercial Banking (2002 – 2003)

Assistant General Manager, Corporate Banking – Trade Finance (1999 – 2002)

**The Hongkong and Shanghai Banking Corporation Limited**

Senior Executive, Payments and Cash Management, Asia-Pacific (1998 – 1999)

Senior Executive, Corporate and Institutional Banking (1997 – 1998)

Qualifications

Fellow – The Hong Kong Institute of Bankers

Fellow – Chartered Institute of Bankers, UK

Master of Business Administration – University of Toronto

**Mr Joseph CHO Tak Chi**

Deputy General Manager and Head of Branch Network and Direct Banking

Aged 52

Joined the Bank in June 1995 (left in 1997) and rejoined in October 2004

Major position held within Hang Seng Group

**Hang Seng Bank Limited** – Deputy General Manager and Head of Branch Network and Direct Banking

Other major appointments

**Hong Kong Deposit Protection Board** – Member of Consultative Committee on Deposit Protection Scheme

**The Hong Kong Association of Banks** – Member of Task Force on Financial Service Delivery Channels; member of Renminbi Services Working Group

**The Hong Kong Institute of Bankers** – Member of China Development Committee

Past major positions

**Hang Seng Bank Limited**

Assistant General Manager and Head of Branch Network and Direct Banking (2006 – 2008)  
Senior Manager and Head of Branch Network and Direct Banking (2005 – 2006)  
Senior Manager and Head of Customer Management and Marketing (2004 – 2005)  
Senior Retail Planning Manager (1995 – 1997)

Qualifications

Certified Financial Management Planner – The Hong Kong Institute of Bankers  
Certified Manager of Financial Advisors and Chartered Insurance Agency Manager – LIMRA International  
Certified Management Consultant – Institute of Management Consultants Hong Kong  
Fellow – Financial Services Institute of Australasia, Australia  
Fellow, Life Management Institute – LOMA  
Graduate Diploma in Management Consulting and Change – The University of Hong Kong  
Master of Science Degree in Management Sciences – University of Manchester, UK

**Mr Andrew LEUNG Wing Lok**

Deputy General Manager and Chief Financial Officer

Aged 47

Joined the Bank in July 1997 (left in 2006) and rejoined in July 2009

Major positions held within Hang Seng Group

**Hang Seng Bank Limited** – Deputy General Manager and Chief Financial Officer; member of Executive Committee

**Hang Seng Bank (China) Limited** – Director

**Hang Seng Insurance Company Limited** – Director

Other major appointment

**Industrial Bank Co Ltd** – Member of Credit Card Centre Management Committee

Past major positions

**Hang Seng Bank Limited**

Senior Manager and Deputy Head of China Business (2005 – 2006)  
Senior Manager and Deputy Head of Greater China Business (2003 – 2005)  
Senior Manager of Corporate Banking (2001 – 2003)  
Senior Manager and Deputy Head of Financial Control (1997 – 2001)

Qualifications

Associate – The Hong Kong Institute of Chartered Secretaries  
Associate – The Institute of Chartered Secretaries and Administrators  
Bachelor of PRC Law – Peking University, PRC  
Bachelor of Social Sciences (Major in Management) – The University of Hong Kong  
Certified Member – Certified Management Accountants Society of British Columbia, Canada  
Fellow – Chartered Association of Certificated Accountants  
Fellow – Hong Kong Institute of Certified Public Accountants  
Master of Science, Data processing – University of Ulster, UK  
Master of Science in Electronic Commerce and Internet Computing – The University of Hong Kong

**Mr Christopher HO Hing Nin**

Deputy General Manager and Chief Technology and Services Officer

Aged 57

Joined the Bank since July 2009

Major positions held within Hang Seng Group

**Hang Seng Bank Limited** – Deputy General Manager and Chief Technology and Services Officer;  
member of Executive Committee

**Hang Seng Real Estate Management Ltd** – Director

**Hang Seng Security Management Ltd** – Director

Other major appointment

**Urban Renewal Authority** – Member of Central Oasis Community Advisory Committee

Past major positions

**The Hongkong and Shanghai Banking Corporation Limited**

Head of Service Delivery Asia Pacific (2009)

Held various senior positions in banking operations and personal financial services (1992 – 2008)

Qualification

MSc in Management Information Systems – Sheffield Hallam University, UK

**Mr Nixon CHAN Lik Sang**

Deputy General Manager and Head of Corporate and Commercial Banking

Aged 57

Joined the Bank since October 2009

Major positions held within Hang Seng Group

**Hang Seng Bank Limited** – Deputy General Manager and Head of Corporate and Commercial  
Banking; member of Executive Committee

**Hang Seng Indexes Company Limited** – Member of Hang Seng Index Advisory Committee

**Hang Seng Insurance Company Limited** – Director

Other major appointments

**Hang Seng School of Commerce** – Director

**Small and Medium Enterprises Committee** – Member

Past major positions

**The Hongkong and Shanghai Banking Corporation Limited**

Senior Executive Commercial Banking (2005 – 2009)

Held various senior positions in commercial banking and personal financial services (1993 – 2005)

Qualification

Bachelor Degree in Business Administration – University of Hawaii, USA

## **REPORT OF THE DIRECTORS**

The Directors have pleasure in presenting their report together with the audited financial statements for the year ended 31 December 2009.

### **Principal Activities**

The Bank and its subsidiaries and associates are engaged in the provision of banking and related financial services.

### **Profits**

The consolidated profit of the Bank and its subsidiaries and associates for the year and the particulars of dividends which have been paid or declared are set out on pages 76 and 110 of the Annual Report respectively.

### **Major Customers**

The Directors believe that the five largest customers of the Bank accounted for less than 30% of the total interest income and other operating income of the Bank for the year.

### **Subsidiaries**

Particulars of the Bank's principal subsidiaries as at 31 December 2009 are set out in note 37 to the financial statements for the year ended 31 December 2009.

### **Share Capital**

No change in either the authorised or issued share capital took place during the year.

### **Donations**

Charitable donations made by the Bank and its subsidiaries during the year amounted to HK\$11.6 million.

### **Reserves**

Profit attributable to shareholders, before dividends, of HK\$13,221 million (2008: HK\$14,099 million) have been transferred to reserves. Other movements in reserves are set out in the consolidated statement of changes in equity.

### **Directors**

The Directors of the Bank who were in office as at the end of the year were Dr Raymond K F Ch'ien, Mrs Margaret Leung, Dr John C C Chan, Dr Marvin K T Cheung, Mr Alexander A Flockhart, Mr Jenkin Hui, Mr William W Leung, Dr Eric K C Li, Dr Vincent H S Lo, Mr Iain J Mackay, Mrs Dorothy K Y P Sit, Mr Richard Y S Tang and Mr Peter T S Wong.

Mr Raymond C F Or and Mr Patrick K W Chan retired from the Board, and Dr Y T Cheng and Dr David W K Sin resigned from the Board with effect from the conclusion of the Bank's 2009 Annual General Meeting ("AGM") held on 6 May 2009. Mr Edgar D Ancona and Mr Joseph C Y Poon resigned from the Board with effect from 1 September 2009 and the close of business on 30 September 2009 respectively.

It is with regret that the Directors report the loss of Mr Peter T C Lee, who passed away on 17 October 2009. He had been a Director of the Bank since August 2002 and made invaluable contributions and offered his wise counsel and guidance to the Bank during his tenure of office.

Mrs Margaret Leung was appointed a Non-executive Director of the Bank with effect from 1 April 2009. After the election of Mrs Leung as a Director of the Bank by shareholders at the 2009 AGM, she

was re-designated Vice-Chairman and Chief Executive of the Bank with effect from the conclusion of the 2009 AGM.

Mrs Dorothy K Y P Sit and Mr William W Leung were appointed Directors of the Bank with effect from 7 August 2009. Mr Iain J Mackay was appointed a Director of the Bank with effect from 1 September 2009. They will retire under the provisions of the Bank's Articles of Association and, being eligible, offer themselves for election at the forthcoming AGM.

The Directors retiring by rotation in accordance with the Bank's Articles of Association are Dr John C C Chan, Dr Eric K C Li and Dr Vincent H S Lo, who, being eligible, offer themselves for re-election at the forthcoming AGM.

No Director proposed for re-election or election, as the case may be, at the forthcoming AGM has a service contract with the Bank which is not determinable by the Bank within one year without payment of compensation (other than statutory compensation).

The biographical details of the Directors of the Bank are set out in the section "Biographical Details of Directors" of this Annual Report.

### Status Of Independent Non-executive Directors

The Bank has received from each Independent Non-executive Director an annual confirmation of his independence pursuant to Rule 3.13 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("Stock Exchange") ("the Listing Rules") and the Bank still considers the Independent Non-executive Directors to be independent.

### Directors' And Alternate Chief Executives' Interests

#### Interests in shares

As at 31 December 2009, the interests of the Directors and Alternate Chief Executives in the shares, underlying shares of equity derivatives and debentures of the Bank and its associated corporations (all within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) disclosed in accordance with the Listing Rules were detailed below.

	Personal Interests (held as beneficial owner)	Family Interests (interests of spouse or child under 18)	Corporate Interests (interests of controlled corporation)	Other Interests	Total Interests	Total Interests as % of the relevant issued share capital
<b>Number of Ordinary Shares of HK\$5 each in the Bank</b>						
<u>Directors:</u>						
Mrs Margaret Leung	21,000	-	-	-	21,000	0.00
Dr John C C Chan	-	-	-	1,000 <sup>(1)</sup>	1,000	0.00
<b>Number of Ordinary Shares of US\$0.50 each in HSBC Holdings plc</b>						
<u>Directors:</u>						
Dr Raymond K F Ch'ien	54,689	-	-	-	54,689	0.00
Mrs Margaret Leung	75,218	-	-	307,666 <sup>(6)</sup>	382,884	0.00
Dr John C C Chan	20,234	-	-	4,371 <sup>(1)</sup>	24,605	0.00
Mr Alexander A Flockhart	269,008	-	-	882,803 <sup>(6)</sup>	1,151,811	0.00
Mr Jenkin Hui	17,111	-	1,895,991 <sup>(2)</sup>	-	1,913,102	0.01
Mr William W Leung	27,088	-	-	46,375 <sup>(6)</sup>	73,463	0.00
Dr Eric K C Li	-	38,199	-	-	38,199	0.00
Mr Iain J Mackay	-	-	-	235,155 <sup>(6)</sup>	235,155	0.00

	Personal Interests (held as beneficial owner)	Family Interests (interests of spouse or child under 18)	Corporate Interests (interests of controlled corporation)	Other Interests	Total Interests	Total Interests as % of the relevant issued share capital
Mrs Dorothy K Y P Sit	29,412 <sup>(3)</sup>	1,031	-	43,125 <sup>(6)</sup>	73,568	0.00
Mr Peter T S Wong	210,331	17,163	-	240,639 <sup>(6)</sup>	468,133	0.00
<u>Alternate Chief Executives:</u>						
Mr Nixon L S Chan	5,729	-	-	41,010 <sup>(6)</sup>	46,739	0.00
Mr Andrew H C Fung	-	-	-	26,477 <sup>(6)</sup>	26,477	0.00
Mr Christopher H N Ho	74,436 <sup>(4)</sup>	41,529 <sup>(5)</sup>	-	10,643 <sup>(6)</sup>	126,608	0.00
Mr Andrew W L Leung	4,428	-	-	-	4,428	0.00
Mr David W H Tam	21,404	9,014	-	27,129 <sup>(6)</sup>	57,547	0.00

Notes:

- (1) 1,000 shares in the Bank and 4,371 shares in HSBC Holdings plc were held by a trust of which Dr John C C Chan and his wife were beneficiaries.
- (2) Mr Jenkin Hui was entitled to fully control the voting power at general meetings of Parc Palais Incorporated, a private company, which beneficially held all of those shares referred to above as his corporate interests.
- (3) 8,046 shares were jointly held by Mrs Dorothy K Y P Sit and her husband.
- (4) 40,000 shares were the underlying shares of the Equity-linked Notes ("ELN") due August 2010 held by Mr Christopher H N Ho.
- (5) 10,800 shares were the underlying shares of the ELN due August 2010 held by Mr Christopher H N Ho's wife.
- (6) These represented interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans to acquire ordinary shares of US\$0.50 each in HSBC Holdings plc and (ii) conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc under the HSBC Share Plans made in favour of Directors and Alternate Chief Executives, as set against their respective names below:

	Options (please refer to the options table below for details)	Conditional awards of shares under the HSBC Share Plans (please refer to the awards table below for further information)	Total
<u>Directors:</u>			
Mrs Margaret Leung	4,197	303,469	307,666
Mr Alexander A Flockhart	4,529	878,274	882,803
Mr William W Leung	15,183	31,192	46,375
Mr Iain J Mackay	1,531	233,624	235,155
Mrs Dorothy K Y P Sit	5,818	37,307	43,125
Mr Peter T S Wong	-	240,639	240,639
<u>Alternate Chief Executives:</u>			
Mr Nixon L S Chan	22,034	18,976	41,010
Mr Andrew H C Fung	4,197	22,280	26,477
Mr Christopher H N Ho	5,961	4,682	10,643



	Options (please refer to the options table below for details)	Conditional awards of shares under the HSBC Share Plans (please refer to the awards table below for further information)	Total
Mr David W H Tam	19,508	7,621	27,129

### Options

As at 31 December 2009, the Directors and Alternate Chief Executives mentioned below held unlisted physically settled options to acquire the number of ordinary shares of US\$0.50 each in HSBC Holdings plc set against their respective names. These options were granted for nil consideration by HSBC Holdings plc.

	Options held as at 31 December 2009	Options exercised/ cancelled during the Director's/ Alternate Chief Executive's term of office in 2009	Exercise price per share	Date granted	Exercisable from	Exercisable until
<u>Directors:</u>						
Mrs Margaret Leung	- 4,197 <sup>(3)</sup> <u>4,197</u>	1,738 <sup>(1)</sup> -	£5.6399 <sup>(2)</sup> HKD37.8797	10 May 2004 29 Apr 2009	1 Aug 2009 1 Aug 2014	31 Jan 2010 31 Jan 2015
Mr Alexander A Flockhart	- 4,529 <u>4,529</u>	1,528 -	£6.1760 <sup>(2)</sup> £3.3116	25 Apr 2007 29 Apr 2009	1 Aug 2010 1 Aug 2014	31 Jan 2011 31 Jan 2015
Mr William W Leung	6,885 7,459 839 <sup>(3)</sup> <u>15,183</u>	- - -	£6.0216 <sup>(2)</sup> £7.2181 <sup>(2)</sup> HKD37.8797	2 May 2003 30 Apr 2004 29 Apr 2009	2 May 2006 30 Apr 2007 1 Aug 2010	1 May 2013 29 Apr 2014 31 Oct 2010
Mr Iain J Mackay	<u>1,531</u>	-	USD11.8824 <sup>(2)</sup>	30 Apr 2008	1 Aug 2011	31 Jan 2012
Mrs Dorothy K Y P Sit	- 3,443 2,375 <u>5,818</u>	2,435 - -	£6.6792 £7.5919 <sup>(2)</sup> HK\$37.8797	24 May 2005 23 Apr 2001 29 Apr 2009	1 Aug 2010 23 Apr 2004 1 Aug 2012	31 Jan 2011 22 Apr 2011 31 Jan 2013
<u>Alternate Chief Executives:</u>						
Mr Nixon L S Chan	5,738 4,820 3,328 3,615 4,533 <u>22,034</u>	- - - - -	£6.5009 <sup>(2)</sup> £7.5919 <sup>(2)</sup> £7.3244 <sup>(2)</sup> £6.0216 <sup>(2)</sup> £7.2181 <sup>(2)</sup>	3 Apr 2000 23 Apr 2001 7 May 2002 2 May 2003 30 Apr 2004	3 Apr 2003 23 Apr 2004 7 May 2005 2 May 2006 30 Apr 2009	2 Apr 2010 22 Apr 2011 6 May 2012 1 May 2013 29 Apr 2014
Mr Andrew H C Fung	<u>4,197<sup>(3)</sup></u>	-	HKD37.8797	29 Apr 2009	1 Aug 2014	31 Jan 2015

	Options held as at 31 December 2009	Options exercised/ cancelled during the Director's/ Alternate Chief Executive's term of office in 2009	Exercise price per share	Date granted	Exercisable from	Exercisable until
Mr Christopher H N Ho	3,443	-	£7.2181 <sup>(2)</sup>	30 Apr 2004	30 Apr 2009	29 Apr 2014
	2,518	-	HKD37.8797	29 Apr 2009	1 Aug 2012	31 Jan 2013
	<u>5,961</u>					
Mr David W H Tam	-	6,885 <sup>(4)</sup>	£6.0216 <sup>(2)</sup>	2 May 2003	2 May 2006	1 May 2013
	-	5,738 <sup>(5)</sup>	£6.5009 <sup>(2)</sup>	3 Apr 2000	3 Apr 2003	2 Apr 2010
	5,738	-	£7.5919 <sup>(2)</sup>	23 Apr 2001	23 Apr 2004	22 Apr 2011
	6,311	-	£7.3244 <sup>(2)</sup>	7 May 2002	7 May 2005	6 May 2012
	7,459	-	£7.2181 <sup>(2)</sup>	30 Apr 2004	30 Apr 2009	29 Apr 2014
	<u>19,508</u>					

Notes:

- (1) At the date of exercise, 8 October 2009, the market value per share was £7.1210.
- (2) Due to HSBC Rights Issue completed in April 2009, the exercise price per share has been adjusted.
- (3) Notifications that Mrs Margaret Leung, Mr William W Leung and Mr Andrew H C Fung held these unlisted physically settled options to acquire shares of US\$0.50 each in HSBC Holdings plc were given by them in January 2010 on their becoming aware of the same.
- (4) At the dates of exercise, 21 and 22 September 2009, the market values per share were £7.2160 and £7.1330 respectively.
- (5) At the date of exercise, 16 November 2009, the market value per share was £7.6120.

Conditional Awards of Shares

As at 31 December 2009, the interests of the Directors and Alternate Chief Executives in the conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc made in favour of them under the HSBC Share Plans were as follows:

	Awards held as at 1 January 2009	Awards made during the Director's/ Alternate Chief Executive's term of office in 2009	Awards released during the Director's/ Alternate Chief Executive's term of office in 2009	Awards held as at 31 December 2009
<u>Directors:</u>				
Mrs Margaret Leung	331,233 <sup>(1)</sup>	-	7,467	303,469 <sup>(2)&amp;(3)</sup>
Mr Alexander A Flockhart	384,644	420,528	16,291	878,274 <sup>(2)&amp;(3)</sup>
Mr William W Leung	35,173	5,354	3,415	31,192 <sup>(2)&amp;(3)</sup>
Mr Iain J Mackay	231,901 <sup>(4)</sup>	-	-	233,624 <sup>(2)</sup>
Mrs Dorothy K Y P Sit	33,983	8,761	2,732	37,307 <sup>(2)&amp;(3)</sup>
Mr Peter T S Wong	142,171	120,902	14,390	240,639 <sup>(2) &amp;(3)</sup>
<u>Alternate Chief Executives:</u>				
Mr Nixon L S Chan	18,976 <sup>(5)</sup>	-	-	18,976
Mr Andrew H C Fung	21,916 <sup>(6)</sup>	-	-	22,280 <sup>(2)</sup>
Mr Christopher H N Ho	4,606 <sup>(7)</sup>	-	-	4,682 <sup>(2)</sup>

	Awards held as at 1 January 2009	Awards made during the Director's/ Alternate Chief Executive's term of office in 2009	Awards released during the Director's/ Alternate Chief Executive's term of office in 2009	Awards held as at 31 December 2009
Mr David W H Tam	7,565 <sup>(8)</sup>	-	-	7,621 <sup>(2)</sup>

Notes:

- (1) This represented the awards held by Mrs Margaret Leung on 1 April 2009 when she was appointed a Director of the Bank.
- (2) This includes additional shares arising from scrip dividends.
- (3) This takes into account the forfeiture of shares under the relevant Share Plan(s).
- (4) This represented the awards held by Mr Iain J Mackay on 1 September 2009 when he was appointed a Director of the Bank.
- (5) This represented the awards held by Mr Nixon L S Chan on 19 October 2009 when he was appointed an Alternate Chief Executive of the Bank.
- (6) This represented the awards held by Mr Andrew H C Fung on 3 June 2009 when he was appointed an Alternate Chief Executive of the Bank.
- (7) This represented the awards held by Mr Christopher H N Ho on 27 August 2009 when he was appointed an Alternate Chief Executive of the Bank.
- (8) This represented the awards held by Mr David W H Tam on 17 September 2009 when he was appointed an Alternate Chief Executive of the Bank.

All the interests stated above represent long positions. As at 31 December 2009, no short positions were recorded in the Register of Directors' and Alternate Chief Executives' Interests and Short Positions required to be kept under section 352 of the SFO.

Save as disclosed in the preceding paragraphs, at no time during the year was the Bank or any of its holding companies or its subsidiaries or fellow subsidiaries a party to any arrangement 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.

No right to subscribe for equity or debt securities of the Bank has been granted by the Bank to, nor have any such rights been exercised by, any person during the year ended 31 December 2009.

### Directors' Interests in Contracts

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

### Directors' Interests In Competing Businesses

Pursuant to Rule 8.10 of the Listing Rules, as at the date of this report, the following Directors had declared interests in the following entities which compete or are likely to compete, either directly or indirectly, with the businesses of the Bank:

Mr Alexander A Flockhart is a member of HSBC Group Management Board and the Chairman, Personal and Commercial Banking and Insurance, and an Executive Director of HSBC Holdings plc. He is an Executive Director of The Hongkong and Shanghai Banking Corporation Limited and a Director of various HSBC Group subsidiaries.

Mrs Margaret Leung is a Group General Manager of HSBC Holdings plc and a Director of The Hongkong and Shanghai Banking Corporation Limited.

Mr William W Leung is a Director of Yantai Bank Co., Ltd. ("Yantai Bank"), in which the Bank holds a 20.0% stake, and HSBC Global Asset Management (Hong Kong) Limited, a subsidiary of The Hongkong and Shanghai Banking Corporation Limited. Yantai Bank conducts general banking business in mainland China.

Mr Iain J Mackay is the Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited and Director of various HSBC Group subsidiaries.

Mr Peter T S Wong is a Group Managing Director of HSBC Holdings plc. He is also the Chief Executive Officer and Executive Director of The Hongkong and Shanghai Banking Corporation Limited; and acts as Chairman and/or Director of its subsidiaries, including Chairman of various rural banks incorporated in mainland China and a Non-executive Director of HSBC Bank Australia Limited. He is a Non-executive Director of Bank of Communications Co., Ltd., which conducts general banking business. He is also a Non-executive Director of Ping An Insurance (Group) Company of China, Ltd., which conducts life insurance, property and casualty insurance and other financial services.

HSBC Holdings plc, through its subsidiaries and associated undertakings, including The Hongkong and Shanghai Banking Corporation Limited, the immediate holding company of the Bank, is engaged in providing a comprehensive range of banking, insurance and related financial services.

The entities in which the Directors have declared interests are managed by separate Boards of Directors and management, which are accountable to their respective shareholders.

Further, Yantai Bank has an Audit and Related Party Transactions Control Committee which is responsible for considering all matters concerning connected party transactions to be entered into by Yantai Bank as required by the laws of mainland China. The majority of members of Yantai Bank's Audit and Related Party Transactions Control Committee are Non-executive Directors.

The Board of the Bank includes six Independent Non-executive Directors whose views carry significant weight in the Board's decisions. The Audit Committee of the Bank, which consists of three Independent Non-executive Directors, meets regularly to assist the Board of Directors in reviewing the financial performance, internal control and compliance systems of the Bank and its subsidiaries. The Bank is, therefore, capable of carrying on its businesses independently of, and at arm's length from, the businesses in which Directors have declared interests.

## Directors' Emoluments

The emoluments of the Directors of the Bank (including executive Directors and Independent Non-executive Directors) on a named basis are set out in note 19 to the financial statements for the year ended 31 December 2009.

## Substantial Interests In Share Capital

The register maintained by the Bank pursuant to the SFO recorded that, as at 31 December 2009, the following corporations had interests or short positions in the shares or underlying shares (as defined in the SFO) in the Bank set opposite their respective names:

Name of Corporation	Number of Ordinary Shares of HK\$5 each in the Bank (Percentage of total)
The Hongkong and Shanghai Banking Corporation Limited	1,188,057,371 (62.14%)
HSBC Asia Holdings BV	1,188,057,371 (62.14%)
HSBC Asia Holdings (UK) Limited	1,188,057,371 (62.14%)
HSBC Holdings BV	1,188,057,371 (62.14%)
HSBC Finance (Netherlands)	1,188,057,371 (62.14%)
HSBC Holdings plc	1,188,057,371 (62.14%)

The Hongkong and Shanghai Banking Corporation Limited is a subsidiary of HSBC Asia Holdings BV, which is a wholly-owned subsidiary of HSBC Asia Holdings (UK) Limited, which in turn is a wholly-owned subsidiary of HSBC Holdings BV. HSBC Holdings BV is a wholly-owned subsidiary of HSBC Finance (Netherlands), which in turn is a wholly-owned subsidiary of HSBC Holdings plc. Accordingly, The Hongkong and Shanghai Banking Corporation Limited's interests are recorded as the interests of HSBC Asia Holdings BV, HSBC Asia Holdings (UK) Limited, HSBC Holdings BV, HSBC Finance (Netherlands) and HSBC Holdings plc.

The Directors regard HSBC Holdings plc to be the beneficial owner of 1,188,057,371 ordinary shares in the Bank (62.14%).

All the interests stated above represent long positions. As at 31 December 2009, no short positions were recorded in the Register of Interests in Shares and Short Positions required to be kept under section 336 of the SFO.

### **Purchase, Sale Or Redemption Of The Bank's Listed Securities**

During the year, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's listed securities.

### **Public Float**

As at the date of this report, the Bank has maintained the prescribed public float under the Listing Rules, based on the information that is publicly available to the Bank and within the knowledge of the Directors of the Bank.

### **Code on Corporate Governance Practices**

Details of the Bank's corporate governance practices are set out in the "Corporate Governance and Other Information" section in this Annual Report.

### **Auditors**

KPMG retire and, being eligible, offer themselves for re-appointment. A resolution for the re-appointment of KPMG as auditors of the Bank will be proposed at the forthcoming Annual General Meeting.

On behalf of the Board

**Raymond Ch'ien**  
Chairman

Hong Kong, 1 March 2010

## CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)

		2009	2008
	note		
Interest income	8	16,390	26,172
Interest expense	8	(2,367)	(9,940)
<b>Net interest income</b>		<b>14,023</b>	<b>16,232</b>
Fee income		5,190	5,704
Fee expense		(869)	(735)
<b>Net fee income</b>	9	<b>4,321</b>	<b>4,969</b>
Trading income	10	1,923	1,455
Net loss from financial instruments designated at fair value	11	(75)	(1,031)
Dividend income	12	16	82
Net earned insurance premiums	13	11,519	12,351
Other operating income	14	1,089	701
<b>Total operating income</b>		<b>32,816</b>	<b>34,759</b>
Net insurance claims incurred and movement in policyholders' liabilities	15	(12,004)	(11,463)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>		<b>20,812</b>	<b>23,296</b>
Loan impairment charges and other credit risk provisions	16	(812)	(2,776)
<b>Net operating income</b>		<b>20,000</b>	<b>20,520</b>
Employee compensation and benefits		(3,378)	(3,452)
General and administrative expenses		(2,748)	(2,851)
Depreciation of premises, plant and equipment		(466)	(432)
Amortisation of intangible assets		(84)	(60)
<b>Total operating expenses</b>	17	<b>(6,676)</b>	<b>(6,795)</b>
<b>Operating profit</b>		<b>13,324</b>	<b>13,725</b>
Gains less losses from financial investments and fixed assets	21	186	267
Net surplus on property revaluation	22	219	79
Share of profits from associates		1,748	1,807
<b>Profit before tax</b>		<b>15,477</b>	<b>15,878</b>
Tax expense	23	(2,256)	(1,779)
<b>Profit for the year</b>		<b>13,221</b>	<b>14,099</b>
Profit attributable to shareholders		<b>13,221</b>	<b>14,099</b>
<i>(Figures in HK\$)</i>			
Earnings per share	25	6.92	7.37

The notes on pages 82 to 227 form part of these financial statements.

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)

	2009	2008
<b>Profit for the year</b>	<b>13,221</b>	<b>14,099</b>
<b>Other comprehensive income</b>		
Premises:		
- unrealised surplus on revaluation of premises	700	171
- deferred taxes	(72)	(24)
Available-for-sale investment reserve:		
- fair value changes taken to/(from) equity:		
-- on debt securities	3,908	(3,627)
-- on equity shares	80	(1,937)
- fair value changes transferred from/(to) income statement:		
-- on impairment	4	555
-- on hedged items	81	(496)
-- on disposal	(9)	(563)
- share of changes in equity of associates:		
-- fair value changes	(26)	(63)
- deferred taxes	(472)	417
Cash flow hedge reserve:		
- fair value changes taken to equity	407	870
- fair value changes transferred to income statement	(864)	(376)
- deferred taxes	69	(76)
Defined benefit plans:		
- actuarial gains/(losses) on defined benefit plans	1,877	(3,016)
- deferred taxes	(309)	497
Exchange differences on translation of:		
- financial statements of overseas branches, subsidiaries and associates	3	622
- others	10	5
Effect of decrease in tax rate on deferred tax balance at 1 January 2008	-	30
<b>Other comprehensive income for the year, net of tax</b>	<b>5,387</b>	<b>(7,011)</b>
<b>Total comprehensive income for the year</b>	<b>18,608</b>	<b>7,088</b>
Total comprehensive income for the year attributable to shareholders	<b>18,608</b>	<b>7,088</b>

## CONSOLIDATED STATEMENT OF FINANCIAL POSITION

at 31 December 2009

(Expressed in millions of Hong Kong dollars)

	note	2009	2008
<b>ASSETS</b>			
Cash and balances with banks and other financial institutions	30	22,086	24,822
Placings with and advances to banks and other financial institutions	31	104,551	69,579
Trading assets	32	66,597	108,389
Financial assets designated at fair value	33	5,450	7,798
Derivative financial instruments	34	5,050	7,104
Advances to customers	35	344,621	329,121
Financial investments	36	241,502	181,159
Investments in associates	38	10,226	8,870
Investment properties	39	2,872	2,593
Premises, plant and equipment	40	7,178	7,090
Interest in leasehold land held for own use under operating lease	41	536	551
Intangible assets	42	4,214	3,385
Other assets	43	11,069	11,506
Deferred tax assets	50	16	201
Total assets		<u>825,968</u>	<u>762,168</u>
<b>LIABILITIES AND EQUITY</b>			
<b>Liabilities</b>			
Current, savings and other deposit accounts	44	636,369	562,183
Deposits from banks		4,870	11,556
Trading liabilities	45	38,391	48,282
Financial liabilities designated at fair value	46	1,456	1,407
Derivative financial instruments	34	4,251	14,945
Certificates of deposit and other debt securities in issue	47	1,826	2,772
Other liabilities	48	15,285	15,448
Liabilities to customers under insurance contracts	49	54,240	43,835
Current tax liabilities	50	52	94
Deferred tax liabilities	50	1,684	711
Subordinated liabilities	51	9,320	9,309
Total liabilities		<u>767,744</u>	<u>710,542</u>
<b>Equity</b>			
Share capital	52	9,559	9,559
Retained profits		37,719	32,518
Other reserves		7,313	3,813
Proposed dividends	26	3,633	5,736
Shareholders' funds		58,224	51,626
Total equity and liabilities		<u>825,968</u>	<u>762,168</u>

The notes on pages 82 to 227 form part of these financial statements.



## STATEMENT OF FINANCIAL POSITION

at 31 December 2009

(Expressed in millions of Hong Kong dollars)

	note	2009	2008
<b>ASSETS</b>			
Cash and balances with banks and other financial institutions	30	18,461	22,071
Placings with and advances to banks and other financial institutions	31	65,624	38,097
Trading assets	32	65,288	107,775
Financial assets designated at fair value	33	174	830
Derivative financial instruments	34	4,916	6,910
Advances to customers	35	299,179	280,255
Amounts due from subsidiaries		87,360	84,907
Financial investments	36	156,715	112,000
Investments in subsidiaries	37	11,584	11,284
Investments in associates	38	2,546	2,543
Investment properties	39	1,883	1,714
Premises, plant and equipment	40	4,198	4,294
Interest in leasehold land held for own use under operating lease	41	536	551
Intangible assets	42	399	342
Other assets	43	8,236	8,872
Deferred tax assets	50	2	187
Total assets		<u>727,101</u>	<u>682,632</u>
<b>LIABILITIES AND EQUITY</b>			
<b>Liabilities</b>			
Current, savings and other deposit accounts	44	612,014	547,385
Deposits from banks		4,469	8,263
Trading liabilities	45	35,071	43,467
Financial liabilities designated at fair value	46	1,003	994
Derivative financial instruments	34	4,180	14,938
Certificates of deposit and other debt securities in issue	47	1,826	2,772
Amounts due to subsidiaries		9,960	8,575
Other liabilities	48	14,333	14,810
Current tax liabilities	50	10	66
Deferred tax liabilities	50	569	-
Subordinated liabilities	51	9,320	9,309
Total liabilities		<u>692,755</u>	<u>650,579</u>
<b>Equity</b>			
Share capital	52	9,559	9,559
Retained profits	53	17,861	15,563
Other reserves	53	3,293	1,195
Proposed dividends	26	3,633	5,736
Shareholders' funds		34,346	32,053
Total equity and liabilities		<u>727,101</u>	<u>682,632</u>

The notes on pages 82 to 227 form part of these financial statements.

## CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)

	2009	2008
<b>Share capital</b>		
At beginning and end of the year	9,559	9,559
<b>Retained profits (including proposed dividends)</b>		
At beginning of year	38,254	38,609
Dividends to shareholders		
'- dividends approved in respect of the previous year	(5,736)	(5,736)
'- dividends declared in respect of the current year	(6,309)	(6,309)
Transfer	345	121
Total comprehensive income for the year	14,798	11,569
	<u>41,352</u>	<u>38,254</u>
<b>Other reserves</b>		
Premises revaluation reserve		
At beginning of the year	3,711	3,639
Transfer	(345)	(121)
Total comprehensive income for the year	628	193
	<u>3,994</u>	<u>3,711</u>
Available-for-sale investment reserve		
At beginning of the year	(3,823)	1,892
Total comprehensive income for the year	3,566	(5,715)
	<u>(257)</u>	<u>(3,823)</u>
Cash flow hedge reserve		
At beginning of the year	562	144
Total comprehensive income for the year	(388)	418
	<u>174</u>	<u>562</u>
Foreign exchange reserve		
At beginning of the year	1,379	757
Total comprehensive income for the year	3	622
	<u>1,382</u>	<u>1,379</u>
Other reserve		
At beginning of the year	1,984	1,856
Costs of share-based payment arrangements	35	127
Total comprehensive income for the year	1	1
	<u>2,020</u>	<u>1,984</u>
<b>Total equity</b>		
At beginning of the year	51,626	56,456
Dividends to shareholders	(12,045)	(12,045)
Cost of share-based payment arrangements	35	127
Total comprehensive income for the year	18,608	7,088
	<u>58,224</u>	<u>51,626</u>

## CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)

	note	2009	2008
<b>Net cash inflow/(outflow) from operating activities</b>	54(a)	<b>65,815</b>	(86,830)
<b>Cash flows from investing activities</b>			
Dividends received from associates		380	287
Purchase of an interest in an associate		(3)	(909)
Purchase of available-for-sale investments		(49,642)	(79,103)
Purchase of held-to-maturity debt securities		(513)	(198)
Proceeds from sale or redemption of available-for-sale investments		48,615	136,534
Proceeds from redemption of held-to-maturity debt securities		182	123
Purchase of fixed assets and intangible assets		(312)	(666)
Proceeds from sale of fixed assets and assets held for sale		443	272
Interest received from available-for-sale investments		4,429	8,188
Dividends received from available-for-sale investments		13	80
Net cash inflow from investing activities		<b>3,592</b>	64,608
<b>Cash flows from financing activities</b>			
Dividends paid		(12,045)	(12,045)
Interest paid for subordinated liabilities		(126)	(396)
Net cash outflow from financing activities		<b>(12,171)</b>	(12,441)
<b>Increase/(decrease) in cash and cash equivalents</b>		<b>57,236</b>	(34,663)
<b>Cash and cash equivalents at 1 January</b>		<b>76,116</b>	113,474
Effect of foreign exchange rate changes		3,407	(2,695)
<b>Cash and cash equivalents at 31 December</b>	54(b)	<b>136,759</b>	76,116

The notes on pages 82 to 227 form part of these financial statements.

## NOTES TO THE FINANCIAL STATEMENTS

year ended 31 December 2009

(Figures expressed in millions of Hong Kong dollars unless otherwise indicated)

### 1. Basis of preparation

(a) The consolidated financial statements comprise the statements of Hang Seng Bank Limited ("the Bank") and all its subsidiaries made up to 31 December. The consolidated financial statements include the attributable share of the results and reserves of associates, based on the financial statements made up to dates not earlier than three months prior to 31 December. All significant intra-group transactions have been eliminated on consolidation. The Bank and its subsidiaries and associates are collectively referred as "the Group".

(b) These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (HKFRSs), which is a collective term that includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards (HKASs), and interpretations (Ints) issued by the Hong Kong Institute of Certified Public Accountants (HKICPA), accounting principles generally accepted in Hong Kong and the requirements of the Hong Kong Companies Ordinance. In addition, these financial statements comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. A summary of the principal accounting policies adopted by the Group is set out in note 4.

The HKICPA has issued certain new and revised HKFRSs that are first effective or available for early adoption for the current accounting period of the Group and the Bank. Note 5 provides information on the changes in accounting policies resulting from initial application of these developments to the extent that they are relevant to the Group for the current and prior accounting periods reflected in these financial statements.

(c) The measurement basis used in the preparation of the financial statements is historical cost except that the following assets and liabilities are stated at fair value as explained in the accounting policies set out below:

- financial instruments classified as trading, designated at fair value and available-for-sale (see note 4(g));
- investment property (see note 4(r));
- other leasehold land and buildings, for which the fair values cannot be allocated reliably between the land and buildings elements at the inception of the lease and the entire lease is therefore classified as a finance lease (see note 4(s)); and
- buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold interest in the land at the inception of the lease (see note 4(s)).

(d) The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. The Group believes that the assumptions that have been made are appropriate and that the financial statements therefore present the financial position and results fairly, in all material respects.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of HKFRSs that have significant effect on the financial statements and major sources of estimation uncertainty are discussed in note 6.

Disclosures under HKFRS 4 "Insurance Contract" and HKFRS 7 "Financial Instrument: Disclosure" relating to the nature and extent of risks have been included in note 62 "Financial risk management".

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 2. Nature of business

The Group is engaged primarily in the provision of banking and related financial services.

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### 3. Basis of consolidation

The consolidated financial statements cover the consolidated positions of Hang Seng Bank Limited and all its subsidiaries, unless otherwise stated, and include the attributable share of results and reserves of its associates. For regulatory reporting, the bases of consolidation are different from the basis of consolidation for accounting purposes. They are set out in notes 34, 55 and 62 to the financial statements.

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### 4. Principal accounting policies

#### (a) Interest income and expense

Interest income and expense for all interest-bearing financial instruments are recognised in "Interest income" and "Interest expense" respectively 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 or, where appropriate, a shorter period, 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.

For impaired loans, the accrual of interest income based on the original terms of the loan is discounted to arrive at the net present value of impaired loans. Subsequent increase of such net present value of impaired loans due to the passage of time is recognised as interest income.

#### (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 reported in "Interest income" (See note 4(a)).

##### *(ii) Rental income from operating lease*

Rental income received under an operating lease is recognised in "Other operating income" in equal instalments over the accounting periods covered by the lease term. Lease incentives granted are recognised in the income statement as an integral part of the aggregate net lease payments receivable. Contingent rentals receivable are recognised as income in the accounting period in which they are earned.

##### *(iii) Dividend income*

Dividend income from unlisted investments is recognised when the shareholder's right to receive payment is established. Dividend income from listed investments is recognised when the share price of the investment is quoted ex-dividend.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### *(iv) Trading income*

Trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading and dividend income from equities held for trading. Gains or losses arising from changes in fair value of derivatives are recognised in "Trading income" to the extent as described in the accounting policy set out in notes 4(h) and 4(i). Gains and losses on foreign exchange trading and other transactions are also reported as "Trading income" except for those gains and losses on translation of foreign currencies recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve in accordance with the accounting policy set out in note 4(z).

### *(v) 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 of financial assets/liabilities designated at fair value and dividends arising on those financial instruments and the changes in fair value of the derivatives managed in conjunction with the financial assets and liabilities designated at fair value.

## **(c) Segment reporting**

The Group's operating segments are determined to be customer group segment because the chief operating decision maker uses customer group information in order to make decisions about allocating resources and assessing performance.

## **(d) Cash and cash equivalents**

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition. Cash and cash equivalents include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, and certificates of deposit.

## **(e) Loans and advances to banks and customers**

Loans and advances to banks and customers include loans and advances originated or acquired by the Group, which have not been classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either borrowers repay their obligations, or the loans are sold or written off, or substantially all the risk and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest rate method, less impairment allowances.

## **(f) Loan impairment**

The Group will recognise losses for impaired loans promptly where there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are assessed either individually for individually significant loans or collectively for loan portfolios with similar credit risk characteristics.

### *(i) Individually assessed loans*

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

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

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

- 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 collateral (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.

Impairment allowances of an individually assessed loan are measured as the difference between the carrying value and the present value of estimated future cash flows discounted at the original effective interest rate of the individual loan. Any loss is charged in the income statement. The carrying amount of impaired loans on the statement of financial position is reduced through the use of an allowance account.

### *(ii) Collectively assessed loans*

Impairment allowances are calculated on a collective basis for the following:

- in respect of losses which have been incurred but have not yet been identified as loans subject to individual assessment for impairment (see section (i)); 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 individually, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment allowance. This allowance covers loans that are impaired at the end of the reporting period but which will not be individually identified as such until some time in the future. The collective impairment allowance is determined after taking into account:

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

### *Homogeneous groups of loans*

Portfolios of small homogeneous loans are collectively assessed using roll rate or historical loss rate methodologies.

### *(iii) Loan write-offs*

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

### *(iv) Reversals of impairment*

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed to the extent it is now excessive by reducing the loan impairment allowance account. The amount of any reversal is recognised in the income statement.

### *(v) Repossessed assets*

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are reported under "Assets held for sale". 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 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 in the income statement.

Financial assets acquired in exchange for loans are classified and reported in accordance with the relevant accounting policies.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### *(vi) Renegotiated loans*

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

### **(g) Financial instruments**

Other than loans and advances to banks and customers, the Group classifies its financial instruments into the following categories at inception, depending on the purpose for which the assets were acquired or the liabilities were incurred.

#### *(i) Trading assets and trading liabilities*

Financial instruments and short positions thereof 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. Trading liabilities also include customer deposits and certificates of deposit with embedded options or other derivatives, the market risk of which was managed in the trading book. Trading assets and 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 and dividends, are recognised in the income statement within "Trading income" as they arise. Upon disposal or repurchase, the difference between the net sale proceeds or the net payment and the carrying value is included in the income statement.

#### *(ii) Financial instruments designated at fair value*

A financial instrument is classified in this category if it meets any one of the criteria set out below, and is so designated by management. 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. Under this criterion, the main classes of financial instruments designated by the Group are:

Long-term debt issues – The interest payable on certain fixed rate long-term debt securities in issue and subordinated liabilities has been matched with the interest on "receive fixed/pay variable" interest rate swaps as part of a documented interest rate risk management strategy.

Fixed rate bonds and related derivatives for economic hedge – The interest receivable on certain fixed rate bonds has been matched with the interest on "receive variable/pay fixed" interest rate swaps as part of a documented interest rate risk management strategy.

An accounting mismatch would arise if the long-term debt issues and fixed rate bonds were accounted for at amortised cost because the related derivatives are measured at fair value with changes in the fair value taken through the income statement. By designating the long-term debt issues and fixed rate bonds at fair value, their movement in the fair value will be recorded in the income statement.

- 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. Under this criterion, certain liabilities under investment contracts and financial assets held to meet liabilities under insurance and investment contracts are the main classes of financial instrument so designated. The Group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.

- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.

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.



## **NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

Gains and losses from changes in the fair value of such assets and liabilities and dividends are recognised in the income statement as they arise, within "Net income from financial instruments designated at fair value". Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with financial assets or financial liabilities designated at fair value are also included in "Net income from financial instruments designated at fair value".

### *(iii) Available-for-sale financial assets*

Financial instruments intended to be held on a continuing basis are classified as available-for-sale, unless they are designated at fair value (see note 4(g)(ii)) or classified as held-to-maturity (see note 4(g)(iv)).

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

### *(iv) 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 allowances.

## **(h) Derivative financial instruments**

Derivative financial instruments ("derivatives") are initially recognised at fair value and carried as assets when the fair value is positive and as liabilities when the 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 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 derivatives are the same as those of a stand-alone derivative, and the combined contract is not designated at fair value. These embedded derivatives are measured at fair value with changes in the fair value recognised in "Trading income".

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.

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.

## **(i) Hedge accounting**

The Group designates certain derivatives as either (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ("fair value hedge"); (ii) hedges of highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ("cash flow hedge"). Hedge accounting is applied to derivatives designated as hedging instruments in fair value or cash flow hedge provided certain criteria are met.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

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.

### *(i) Fair value hedge*

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement within "Trading income", together with changes in the fair value of the asset or liability or group thereof that are attributable to the hedged risk.

If the hedging relationship no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity.

### *(ii) Cash flow hedge*

The effective portion of changes in the fair value of derivatives that are designated and qualified as cash flow hedge are recognised in other comprehensive income and accumulated separately in equity. Any gain or loss relating to an ineffective portion is recognised immediately in the income statement within "Trading income".

For cash flow hedge of a recognised asset or liability, the associated cumulative gain or loss is reclassified from equity to the income statement in the same periods during which the hedged cash flow affect profit and loss.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss at that time remains in 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 recognised in other comprehensive income is immediately reclassified to the income statement.

### *(iii) Hedge effectiveness testing*

In order to qualify for hedge accounting, the Group carries out prospective effectiveness testing to demonstrate that it expects the hedge to be highly effective at the inception of the hedge and throughout its life. Actual effectiveness (retrospective effectiveness) is also demonstrated on an ongoing basis.

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

For fair value hedge relationships, the Group utilises the cumulative dollar offset method or regression as effectiveness testing methodology. For cash flow hedge relationships, the Group utilises the change in variable cash flow method or capacity test or the cumulative dollar offset method using the hypothetical derivative approach.

For prospective effectiveness, the hedging instrument is 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 change in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent for the hedge to be deemed effective.

### *(iv) Derivatives that do not qualify for hedge accounting*

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in "Trading income", except where derivatives are managed in conjunction 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".

## **(j) Sale and repurchase agreements**

Where securities are sold subject to commitment to repurchase them at a pre-determined price, they remain on the statement of financial position and a liability is recorded in respect of the consideration received in "Deposits from banks" where the counterparty is a bank, or in "Current, savings and other deposit accounts" where the counterparty is a non-bank. Conversely, securities purchased under analogous commitments to resell are not recognised on the statement of financial position and the consideration paid is recorded in "Placements with and advances to banks and other financial institutions" where the counterparty is a bank, or in "Advance to customers" where the counterparty is a non-bank. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

## **NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

### **(k) Offsetting financial instruments**

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

### **(l) Application of trade date accounting**

Except for loans and advances and deposits, all financial assets, liabilities and instruments are accounted for on trade date basis.

### **(m) 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 control is not retained. Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged or cancelled or expires.

### **(n) Determination of fair value**

The fair value of financial instruments is based on their quoted market prices at the end of the reporting period, without any deduction for estimated future selling costs. Financial assets are priced at current bid prices while financial liabilities are priced at current asking prices.

If a quoted market price is not available on a recognised stock exchange or from a broker / dealer for non-exchange-traded financial instruments, the fair value of the instrument is estimated using valuation techniques, including use of recent arm's-length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow techniques, option pricing models or any other valuation technique that provides a reliable estimate of prices obtained in actual market transactions.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates, and the discount rate used is a market rate at the end of the reporting period applicable for an instrument with similar terms and conditions. Where other pricing models are used, inputs are based on market data at the end of the reporting period. Fair values for unquoted equity investments are estimated, if possible, using applicable price/earnings ratios for similar listed companies adjusted to reflect the specific circumstances of the issuer.

Investments in other unlisted open-ended investment funds are recorded at the net asset value per share as reported by the managers of such funds.

### **(o) Subsidiaries**

A subsidiary is a corporate entity in which the Group, directly or indirectly, holds more than half of the issued share capital or controls more than half of the voting power or controls the composition of the board of directors, or a non-corporate entity the Group otherwise controls, directly or indirectly, by way of having the power to govern its financial and operating policies so that the Group obtains benefits from these activities.

A subsidiary is fully consolidated into the consolidated financial statements from the date that control commences until the date that control ceases.

In the Bank's statement of financial position, an investment in subsidiary is stated at cost less impairment allowances.

### **(p) Associates**

An associate is an entity over which the Group or the Bank has the ability to significantly influence, but not control over its management, including participation in the financial and operating policy decision.

## **NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

An investment in an associate is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income statement includes the Group's share of the post-acquisition, post tax results of the associate and any impairment losses for the year, whereas the Group's share of the post-acquisition post-tax items of the associate's other comprehensive income is recognised in the consolidated statement of comprehensive income.

Unrealised gains on transactions between the Group and its associate are eliminated to the extent of the Group's interest in the associate. Unrealised losses are also eliminated to the extent of the Group's interest in the associate unless the transaction provides evidence of an impairment of the asset transferred.

In the Bank's statement of financial position, investment in associate is stated at cost less impairment allowances.

### **(q) Goodwill and intangible assets**

(i) Goodwill arises on business combinations, including the acquisition of subsidiaries or associates when the cost of acquisition exceeds the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired and is reported in the consolidated statement of financial position. Goodwill on acquisitions of associates is included in "Investments in associates". 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. Goodwill is tested for impairment annually by comparing the recoverable amount from a cash-generating unit with the carrying value 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 is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less any accumulated impairment losses.

Any excess of the Group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business over the cost to acquire is recognised immediately in the income statement.

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

(ii) Intangible assets include the value of in-force long-term assurance business, acquired software licences and capitalised development costs of computer software programmes. The value of in-force long-term assurance business is stated at a valuation determined annually in consultation with actuaries using the methodology as described in note 4(ac). Computer software acquired is stated at cost less amortisation and impairment allowances. Amortisation of computer software is charged to the income statement over its useful life. Costs incurred in the development phase of a project to produce application software for internal use are capitalised and amortised over the software's estimated useful life, usually five years. A periodic review is performed on intangible assets to confirm that there has been no impairment.

### **(r) Investment property**

Investment properties are land and/or buildings which are owned and/or held under a leasehold interest to earn rental income and/or for capital appreciation. These include land held for a currently undetermined future use.

Investment properties are stated in the statement of financial position at fair value. Any gain or loss arising from a change in fair value is recognised in the income statement.

### **(s) Premises, plant and equipment**

(i) The following properties held for own use are stated in the statement of financial position at their revalued amount, being their fair value at the date of the revaluation less any subsequent accumulated depreciation:

- land held under operating leases and buildings thereon, where the fair value of the leasehold interest in the land and buildings cannot be measured separately at the inception of the lease and the building is not clearly held under an operating lease; and

- buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold interest in the land at the inception of the lease.

Revaluations are performed by professionally qualified valuers with sufficient regularity to ensure that the carrying amount of these assets does not differ materially from that which would be determined using fair value at the end of the reporting period.

## **NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

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 property, and are thereafter taken to other comprehensive income and are accumulated separately in the "Premises revaluation reserve". Deficits arising on revaluation, are firstly set off against any previous revaluation surpluses included in the "Premises revaluation reserve" in respect of the same property, and are thereafter to the income statement.

Depreciation is calculated to write-off the valuation of the property over their estimated useful lives as follows:

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

On revaluation of the property, depreciation accumulated during the year will be eliminated. Depreciation charged on revaluation surplus of the properties is transferred from "Premises revaluation reserve" to "Retained profits".

On disposal of the property, the profit and loss is calculated as the difference between the net sales proceeds and the net carrying amount and recognised in the income statement. Surpluses relating to the property disposed of included in the "Premises revaluation reserve" are transferred as movements in reserves to "Retained profits".

(ii) Furniture, plant and other equipment, is stated at cost less depreciation calculated on the straight line basis to write off the assets over their estimated useful lives, which are generally between 3 and 10 years. On disposal, the profit and loss is calculated as the difference between the net sales proceeds and the net carrying amount.

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

### **(t) Interest in leasehold land held for own use under operating lease**

Leasehold interest in the land held for own use is accounted for as being held under an operating lease where the fair value of the interest in any buildings situated on the leasehold land could be measured separately from the fair value of the leasehold interest in land at the time the lease was first entered into by the Group. The interest in leasehold land is stated at cost in the statement of financial position and is amortised to the income statement on a straight-line basis over the remaining lease term.

### **(u) Finance and operating leases**

Leases which transfer substantially all the risks and rewards of ownership to the lessees are classified as finance leases. Leases which do not transfer substantially all the risks and rewards of ownership to the lessees are classified as operating leases, with the exceptions of land and building held under a leasehold interest as set out in notes 4(r) & 4(s).

#### *(i) Finance leases*

Where the Group is a lessor under finance leases, an amount representing the net investment in the lease is included in the statement of financial position as loans and advances to customers. Hire purchase contracts having the characteristics of a finance lease are accounted for in the same manner as finance leases. Impairment allowances are accounted for in accordance with the accounting policies set out in note 4(f).

Where the Group acquires the use of assets under finance leases, the amount representing the fair value of the leased asset, or, if lower, the present value of the minimum payments of such assets is included in fixed assets and the corresponding liabilities, net of finance charges, are recorded as obligations under finance leases. Depreciation is provided at rates which write off the cost or valuation of the assets over the term of the relevant lease or, where it is likely the Group will obtain ownership of the asset, the life of the asset, as set out in note 4(s). Impairment allowances are accounted for in accordance with the accounting policy as set out in note 4(v). Finance charges implicit in the lease payments are charged to the income statement over the period of the leases so as to produce an approximately constant periodic rate of charge on the remaining balance of the obligations for each accounting period. Contingent rentals are written off as an expense of the accounting period in which they are incurred.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### *(ii) Operating leases*

Where the Group leases out assets under operating leases, the assets are included in the statement of financial position according to their nature and, where applicable. Rental revenue arising from operating lease is recognised in accordance with the Group's revenue recognition policies as set out in note 4(b)(ii).

### **(v) Impairment of assets**

The carrying amount of the Group's assets are reviewed at the end of each reporting period to determine whether there is objective evidence of impairment. If any such evidence exists, the carrying amount is reduced to the estimated recoverable amount by means of a charge to the income statement.

The accounting policies on impairment losses on loans and receivables and goodwill are set out in notes 4(f) and 4(q) respectively.

### *(i) Held-to-maturity investments*

For held-to-maturity investments, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition of these assets) on an individual basis.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement. The reversal of impairment is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years.

### *(ii) Available-for-sale financial assets*

At the end of each reporting period, an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of 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 reclassified from equity to the income statement.

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

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 further objective evidence of impairment. Further 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 further impacted that can be reliably measured. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income and accumulated separately 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; and

– 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 in other comprehensive income and accumulated separately in equity. Impairment losses recognised on the 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 in relation to the acquisition cost of the equity security.

### *(iii) Other assets*

Internal and external sources of information are reviewed at the end of each reporting period to identify indications that the following types of assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

- premises and equipment (other than properties carried at revalued amounts);
- pre-paid interests in leasehold land classified as "Interest in leasehold land held for own use under operating lease";
- investments in subsidiaries and associates; and
- intangible assets.

If any such indication exists, the asset's recoverable amount is estimated and impairment losses recognised.

### *Calculation of recoverable amount*

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the assets. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

### *Recognition of impairment losses*

An impairment loss is recognised in the income statement whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the cash-generating unit (or group of units) and then, to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

### *Reversals of impairment losses*

In respect of assets other than goodwill, an impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount. An impairment loss in respect of goodwill is not reversed.

A reversal of impairment losses is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to the income statement in the year in which the reversals are recognised.

## **(w) Income tax**

Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised in other comprehensive income or directly in equity, in which case the relevant amounts of tax are recognised in other comprehensive income or directly in equity, respectively. Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset.

Current tax is the expected tax payable on the taxable profits for the year, using tax rates enacted or substantively enacted at the end of the reporting period, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are settled on an individual taxable entity basis.

Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purpose and their tax bases. Deferred tax assets also arise from unused tax losses and unused tax credits.

Deferred tax liabilities are generally recognised for all taxable temporary differences. Deferred tax assets are recognised to the extent that it is probable that taxable profits will be available, against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates that are expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are not discounted. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to offset exists in the entity.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

The carrying amount of deferred tax assets/ liabilities is reviewed at the end of each reporting period and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the related tax benefit to be utilised.

### **(x) Employee benefits**

(i) Salaries, annual bonuses, paid annual leave, leave passage and the cost to the Group of non-monetary benefits are accrued in the year in which the associated services are rendered by the employees. Provision is made in respect of paid leave entitlement accumulated during the year, which can be carried forward into future periods for compensated absence or payment in lieu if the employee leaves employment.

(ii) The Group provides retirement benefits for staff members and operates defined benefit and defined contribution schemes and participates in mandatory provident fund schemes in accordance with the relevant laws and regulations.

The retirement benefit costs of defined benefit schemes charged to the income statement are determined by calculating the current service cost, interest cost and expected return on scheme assets in accordance with a set of actuarial assumptions. Any actuarial gains and losses are fully recognised in shareholders' equity and presented in the statement of changes in equity in the period in which they arise.

The Group's net obligation in respect of defined benefit schemes is calculated separately for each scheme by estimating the amount of future benefit that employees have earned in return for their service in the current and prior years; that benefit is discounted to determine the present value, and the fair value of any scheme assets is deducted. The discount rate is the yield at the end of the reporting period on high quality corporate bonds that have maturity dates approximating the terms of the Group's obligation. The calculation is performed by a qualified actuary using the Projected Unit Credit Method.

Where the calculation of the Group's net obligation results in a negative amount, the asset recognised is limited to the present value of any future refunds from the scheme or reductions in future contributions to the scheme less past service cost.

The retirement benefit costs of defined contribution schemes and mandatory provident fund schemes are the contributions made in accordance with the relative scheme rules and are charged to the income statement of the year.

### **(y) 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 the "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.

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 vesting period.



## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### **(z) Translation of foreign currencies**

Foreign currency transactions during the year are translated at the foreign exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated at the foreign exchange rates ruling at the end of the reporting period. Exchange gains and losses are recognised in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the foreign exchange rates ruling at the transaction dates. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated using the foreign exchange rates ruling at the dates the fair value was determined.

Exchange differences arising from the re-translation of opening foreign currency net investments and the related cost of hedging, if any, and exchange differences arising from re-translation of the result for the year from the average rate to the exchange rate ruling at the year-end, are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of separate subsidiary financial statements. In the consolidated financial statements, these exchange differences are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve.

### **(aa) Provisions**

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

### **(ab) Financial guarantees**

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of the loans or debt instruments.

Financial guarantee liabilities are initially recognised at their fair value, and the initial fair value is amortised over the life of the financial guarantee. The guarantee liability is subsequently carried at the higher of this amortised amount and the present value of any expected payment (when a payment under the guarantee has become probable). Financial guarantees are included within other liabilities.

### **(ac) Insurance contracts**

Through its insurance subsidiaries, the Group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

A contract issued by the Group that transfers financial risk, without significant insurance risk, is classified as an investment contract, and is accounted for as a financial instrument. The financial assets held by the Group for the purpose of meeting liabilities under insurance and investment contracts are classified and accounted for based on their classifications as set out in notes 4(d) to 4(i).

Insurance contracts are accounted for as follows:

#### ***Net earned insurance premiums***

Gross insurance premiums for general insurance business are accounted for in the period in which the amount is determined, which is generally the period in which the risk commences. The proportion of premiums written in the accounting year relating to the period of risk after the end of the reporting period is carried forward as a provision for unearned premium and is calculated on a daily 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 recognised.

Reinsurance premiums, netted by the reinsurers' share of provision for unearned premiums, are accounted for in the same accounting year as the premiums for the direct insurance to which they relate.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### **Claims and reinsurance recoveries**

Gross insurance claims for general insurance business include paid claims and movements in outstanding claims reserves. Full provision for outstanding claims is made for the estimated cost of all claims notified but not settled at the end of the reporting period, and claims incurred but not reported by that date. Provision is also made for the estimated cost of servicing claims notified but not settled at the end of the reporting period, reduced by estimates of salvage and subrogation recoveries, and to meet expenses on claims incurred but not reported. Reinsurance recoveries are assessed in a manner similar to the assessment of provision for outstanding claims.

Gross insurance claims for life assurance reflect the total cost of claims arising during the year, including policyholder cash dividend payment upon policy anniversary. The technical reserves for non-linked liabilities (long-term business provision) are calculated based on actuarial principles. The technical 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. Reinsurance recoveries are accounted for in the same period as the related claims.

### **Deferred acquisition costs**

The deferred acquisition costs related to insurance contract, such as initial commission, are amortised over the period in which the related revenues are earned.

### **Value of long-term insurance business**

A value is placed on insurance contracts that are classified as long-term assurance business, and are in force at the end of the reporting period.

The value of the 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 future mortality, lapse rates, levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. Movements in the value of in-force long-term assurance business are included in other operating income on a pre-tax basis. The value of in-force long-term insurance business is reported under "Intangible assets" in the statement of financial position.

### **(ad) Investment contracts**

Customer liabilities under unit-linked investment contracts are measured at fair value and reported under "Financial liabilities designated at fair value". The linked financial assets are measured 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 fee receivables are recognised in the income statement over the period of the provision of the investment management services.

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are capitalised and amortised over the period the investment management services are provided.

### **(ae) Debt securities in issue and subordinated liabilities**

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", except for those issued for trading or designated at fair value, which are carried at fair value and reported under the "Trading liabilities" and "Financial liabilities designated at fair value" in the statement of financial position.

### **(af) Assets held for sale**

Non-current assets that are expected to be recovered primarily through sale rather than through continuing use are classified as held for sale. Immediately before classification as held for sale, the assets are remeasured in accordance with the Group's accounting policies set out elsewhere in note 4. Thereafter generally the assets are measured at the lower of their carrying amount and fair value less cost to sell. Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### **(ag) Related parties**

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel, significant shareholders and/or their close family members) or other entities which are under the significant influence of related parties of the Group and post employment benefit scheme. Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and its holding companies, directly or indirectly, including any directors (whether executive or otherwise) and Executive Committee members of the Bank and its holding companies.

### **(ah) Dividends**

Dividends proposed or declared after the end of the reporting period are disclosed as a separate component of shareholders' equity.

## **5. Changes in accounting policies**

During the year the Group adopted the following HKFRSs and amendments to HKFRSs:

Amendments to HKFRS 7 "Financial Instruments: Disclosures - Improving Disclosures about Financial Instruments". The amendments introduce a three level fair value hierarchy, which reflects the availability of observable market inputs when estimating fair values and clarifies the quantitative disclosures about the liquidity risk associated with financial instruments. The adoption of the amendment has no effect on the results reported in the consolidated financial statements.

HKFRS 8 "Operating Segments" (HKFRS 8), which replaced HKAS 14 "Segment Reporting". HKFRS 8 requires segment information to be reported using the same measure reported to the chief operating decision maker for the purpose of making decisions about allocating resources to the segment and assessing its performance. The Group's HKFRS 8 operating segments are determined to be customer group segment because the chief operating decision maker uses customer group information in order to make decisions about allocating resources and assessing performance. The five operating segments, or customer groups, are: Personal Financial Services, Commercial Banking, Corporate Banking, Treasury, and "Other". Segment information provided to the chief operating decision maker is on HKFRS basis.

HKAS 1 (Revised 2007) "Presentation of Financial Statements". The revised standard aims to improve users' ability to analyse and compare information given in financial statements. The adoption of the revised standard has no effect on the results reported in the consolidated financial statements. It does, however, result in certain presentational changes in the consolidated financial statements, including:

- the presentation of all items of income and expenditure in two financial statements, the "Consolidated income statement" and the "Consolidated statement of comprehensive income";
- the presentation of the "Consolidated statement of changes in equity" as a financial statement, which replaces the "Reserves" note on the financial statements; and
- the adoption of revised title "Statement of financial position" for the "Balance sheet".

During the year, the Group also adopted a number of HKFRSs or amendments to HKFRSs which had an insignificant effect on the consolidated financial statements. These are:

- Amendments to HKAS 27 "Consolidated and Separate Financial Statements" – "Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate";
- HKAS 23 (Revised 2007) "Borrowing Costs";
- Amendments to HKAS 32 "Financial Instruments: Presentation" and HKAS 1 "Presentation of Financial Statements" – "Puttable Financial Instruments and Obligations Arising on Liquidation";
- Amendments to HKFRS 2 "Share-based Payment" – "Vesting Conditions and Cancellations";
- Improvements to HKFRSs (2008);

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

- Hong Kong (IFRIC) Interpretation 13 “Customer Loyalty Programmes” ;
- Hong Kong (IFRIC) Interpretation 16 “Hedges of a Net Investment in a Foreign Operation”.

### 6. Accounting estimates and judgements

Key sources of estimation uncertainty and critical judgements in applying the Group's accounting policies which have significant effect on the financial statements are set out below.

#### (a) Key sources of estimation uncertainty

##### *(i) Impairment allowances on loans and advances*

The Group periodically reviews its loan portfolios to assess whether impairment allowances exist. In determining whether impairment allowances should be recorded in the income statement, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the Group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

##### *(ii) Valuation of financial instruments*

The Group's accounting policy for valuation of financial instruments is included in note 4(n) and is discussed further within note 63 “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; and
- 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 limitation. 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 of 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.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

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

### *(iii) 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 42(a). 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 62(d).

### **(b) Critical accounting judgements in applying the Group's accounting policies**

#### *(i) Impairment of available-for-sale financial assets*

For available-for-sale financial assets, a significant or prolonged decline in fair value below cost is considered to be objective evidence of impairment. Judgement is required when determining whether a decline in fair value has been significant or prolonged. In making this judgement, the historical data on market volatility as well as the price of the specific investment are taken into account. The Group also takes into account other factors, such as industry and sector performance and financial information regarding the issuer/investee.

#### *(ii) Held-to-maturity investments*

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity investments if the Group has the intention and ability to hold them until maturity. In evaluating whether the requirements to classify a financial asset as held-to-maturity are met, management makes significant judgements. Failure in correctly assessing the Group's intention and ability to hold specific investments until maturity may result in reclassification of the whole portfolio as available-for-sale.

#### *(iii) Income taxes*

Determining income tax provisions involves judgement on the future tax treatment of certain transactions. The Group carefully evaluates tax implications of transactions and tax provisions are set up accordingly. The tax treatment of such transactions is reconsidered periodically to take into account all changes in tax legislations.

### **7. Possible impact of amendments, new standards and interpretations issued but not yet effective for the year ended 31 December 2009**

The HKICPA has issued a number of amendments to HKFRS and Interpretations which are not yet effective for the year ended 31 December 2009 and which have not been adopted in these financial statements.

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:

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

- 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 consolidated financial statements of the Group will depend on the incident and timing of business combination occurring on or after 1 January 2010.

The HKICPA issued an amendment to HKAS 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. This amendment will have no effect 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 (IFRIC)-Int 17 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 of HKFRSs 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 (such as a supply of electricity, gas or water). The Group does not expect adoption of HK (IFRIC) -Int 18 to have an effect on the consolidated financial statements.

An amendment to Hong Kong (IFRIC) Interpretation 9 and HKAS 39 – "Embedded Derivatives" was issued by the HKICPA in March 2009 and is effective for annual periods ending on or after 30 June 2009. The amendment clarifies the accounting treatment of embedded derivatives for entities that make use of the amendment to HKAS 39 "Financial Instruments: Recognition and Measurement" and to HKFRS 7 "Financial Instruments: Disclosures" – "Reclassification of Financial Assts" (The "Reclassification Amendment") which was adopted by the Group during 2008. Adoption of the amendment will not have significant effect on the consolidated financial statements.

The HKICPA issued "Improvements to HKFRSs" in May 2009, 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 2010, 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 2 "Share-based Payment" – "Group Cash-settled Share-based Payment Transactions" in July 2009, which is effective for annual periods beginning on or after 1 January 2010. The amendments clarify that an entity that receives goods or services in a share-based payment arrangement must account for those goods or services no matter which entity in the Group settles the transaction, and no matter whether the transaction is settled in shares or cash. It was also clarified that in HKFRS 2 a "Group" includes only a parent and its subsidiaries. The Group does not expect adoption of the amendment to have a significant effect of the consolidated financial statements.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

The HKICPA issued HKAS 24 (Revised 2009) “Related Party Disclosures” in November 2009, which is effective for annual periods beginning on or after 1 January 2011. The revised standard simplifies the disclosure requirements for government-related entities and clarifies the definition of a related party. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

HKFRS 9 ‘Financial Instruments’ (‘HKFRS 9’) was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2013 with earlier application permitted.

Under HKFRS 9, financial assets are classified into two measurement categories: amortised cost or fair value. These two categories replace the four categories under the current HKAS 39 ‘Financial Instruments: Recognition and Measurement’. Under HKFRS 9, financial assets are classified on the basis of both an entity’s business model for managing groups of financial assets and the contractual cash flow characteristics of the individual assets.

The Group is presently studying the implications of applying HKFRS 9 before the mandatory adoption date. Based on a preliminary, high level analysis, it appears that the majority of financial assets included in ‘Advances to customers’ will continue to be measured at amortised cost less impairment. The impact on other financial assets continues to be evaluated.

The HKICPA issued Hong Kong (IFRIC) Interpretation 19 “Extinguishing Financial Liabilities with Equity Instruments” in December 2009, which is effective for annual periods beginning on or after 1 July 2010. This interpretation provides guidance on how to account for the extinguishment of a financial liability by the issue of equity instruments. The Group does not expect adoption of this amendment to have a significant effect on the consolidated financial statements.

The HKICPA issued an Amendment to Hong Kong (IFRIC) Interpretation 14 “HKAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction” – “Prepayments of a Minimum Funding Requirement” in December 2009, which is effective for annual periods beginning on or after 1 January 2011. The amendment applies in the limited circumstances when an entity is subject to minimum funding requirements and makes an early payment of contributions to cover those requirements. The amendment permits such an entity to treat the benefit of such an early payment as an asset. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 8 Interest income/interest expense

#### (a) Interest income

	2009	2008
Interest income arising from:		
- financial assets that are not at fair value through profit or loss	15,950	25,599
- trading assets	320	363
- financial assets designated at fair value	120	210
	<u>16,390</u>	<u>26,172</u>
of which:		
- interest income from listed investments	1,801	3,204
- interest income from unlisted investments	3,569	5,701
- interest income from impaired financial assets	46	18

#### (b) Interest expense

	2009	2008
Interest expense arising from:		
- financial liabilities that are not at fair value through profit or loss	1,799	8,322
- trading liabilities	554	1,574
- financial liabilities designated at fair value	14	44
	<u>2,367</u>	<u>9,940</u>
of which:		
- interest expense from debt securities in issue maturing after five years	-	11
- interest expense from customer accounts maturing after five years	-	1
- interest expense from subordinated liabilities	126	396

### 9 Net fee income

	2009	2008
- stockbroking and related services	1,566	1,359
- retail investment funds	604	1,084
- structured investment products	28	341
- insurance	190	98
- account services	291	282
- private banking service fee	129	234
- remittances	217	212
- cards	1,413	1,304
- credit facilities	135	132
- trade services	379	409
- other	238	249
Fee income	5,190	5,704
Fee expense	(869)	(735)
	<u>4,321</u>	<u>4,969</u>
of which:		
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 nor designated at fair value	1,658	1,586
- fee income	2,217	2,124
- fee expense	(559)	(538)
Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers	383	620
- fee income	557	773
- fee expense	(174)	(153)



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 10 Trading income

	2009	2008
Foreign exchange	1,792	1,384
Gains/(losses) from hedging activities:		
- fair value hedge		
-- on hedging instruments	74	(515)
-- on the hedged items attributable to the hedged risk	(81)	496
- cash flow hedge		
-- net hedging income	16	1
Securities, derivatives and other trading activities	122	89
	<u>1,923</u>	<u>1,455</u>

### 11 Net loss from financial instruments designated at fair value

	2009	2008
Net loss on assets designated at fair value		
which back insurance and investment contracts	(54)	(1,045)
Net change in fair value of other financial instruments designated at fair value	(21)	14
	<u>(75)</u>	<u>(1,031)</u>
of which dividend income from:		
- listed investments	1	35
- unlisted investments	1	1
	<u>2</u>	<u>36</u>

### 12 Dividend income

	2009	2008
Dividend income:		
- listed investments	3	66
- unlisted investments	13	16
	<u>16</u>	<u>82</u>

### 13 Net earned insurance premiums

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
<b>2009</b>				
Gross written premiums	422	11,237	15	11,674
Movement in unearned premiums	(18)	-	-	(18)
Gross earned premiums	<u>404</u>	<u>11,237</u>	<u>15</u>	<u>11,656</u>
Gross written premiums ceded to reinsurers	(93)	(59)	-	(152)
Reinsurers' share of movement in unearned premiums	15	-	-	15
Reinsurers' share of gross earned premiums	<u>(78)</u>	<u>(59)</u>	<u>-</u>	<u>(137)</u>
Net earned insurance premiums	<u>326</u>	<u>11,178</u>	<u>15</u>	<u>11,519</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 13 Net earned insurance premiums (continued)

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2008				
Gross written premiums	411	12,023	46	12,480
Movement in unearned premiums	(8)	-	-	(8)
Gross earned premiums	<u>403</u>	<u>12,023</u>	<u>46</u>	<u>12,472</u>
Gross written premiums ceded to reinsurers	(80)	(46)	-	(126)
Reinsurers' share of movement in unearned premiums	5	-	-	5
Reinsurers' share of gross earned premiums	<u>(75)</u>	<u>(46)</u>	<u>-</u>	<u>(121)</u>
Net earned insurance premiums	<u><u>328</u></u>	<u><u>11,977</u></u>	<u><u>46</u></u>	<u><u>12,351</u></u>

### 14 Other operating income

	2009	2008
Rental income from investment properties	149	138
Movement in present value of in-force long-term insurance business	760	382
Other	180	181
	<u><u>1,089</u></u>	<u><u>701</u></u>

### 15 Net insurance claims incurred and movement in policyholders' liabilities

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2009				
Claims, benefits and surrenders paid	119	1,811	19	1,949
Movement in provisions	(16)	10,066	35	10,085
Gross claims incurred and movement in policyholders' liabilities	103	11,877	54	12,034
Reinsurers' share of claims, benefits and surrenders paid	(10)	(18)	-	(28)
Reinsurers' share of movement in provisions	(1)	(1)	-	(2)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	<u>(11)</u>	<u>(19)</u>	<u>-</u>	<u>(30)</u>
Net insurance claims incurred and movement in policyholders' liabilities	<u><u>92</u></u>	<u><u>11,858</u></u>	<u><u>54</u></u>	<u><u>12,004</u></u>
2008				
Claims, benefits and surrenders paid	130	646	30	806
Movement in provisions	16	10,745	(41)	10,720
Gross claims incurred and movement in policyholders' liabilities	146	11,391	(11)	11,526
Reinsurers' share of claims, benefits and surrenders paid	(32)	(14)	-	(46)
Reinsurers' share of movement in provisions	(9)	(8)	-	(17)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	<u>(41)</u>	<u>(22)</u>	<u>-</u>	<u>(63)</u>
Net insurance claims incurred and movement in policyholders' liabilities	<u><u>105</u></u>	<u><u>11,369</u></u>	<u><u>(11)</u></u>	<u><u>11,463</u></u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 16 Loan impairment charges and other credit risk provisions

	Group		Bank	
	2009	2008	2009	2008
Loan impairment charges (note 35(b)):				
- individually assessed	(310)	(925)	(285)	(808)
- collectively assessed	(502)	(476)	(503)	(378)
	<u>(812)</u>	<u>(1,401)</u>	<u>(788)</u>	<u>(1,186)</u>
of which:				
- new and additional	(1,104)	(1,505)	(1,028)	(1,272)
- releases	230	48	194	43
- recoveries	62	56	46	43
	<u>(812)</u>	<u>(1,401)</u>	<u>(788)</u>	<u>(1,186)</u>
Other credit risk provisions	-	(1,375)	-	(846)
	<u>(812)</u>	<u>(2,776)</u>	<u>(788)</u>	<u>(2,032)</u>

There was no impairment charge provided for available-for-sale debt securities by the Group and the Bank (2008: HK\$1,375 million and HK\$846 million). No impairment loss was made in relation to held-to-maturity investments in 2009 (2008: Nil).

### 17 Operating expenses

	2009	2008
Employee compensation and benefits:		
- salaries and other costs	2,714	2,817
- performance-related pay*	377	462
- retirement benefit costs		
-- defined benefit scheme (note 59(a))	213	104
-- defined contribution scheme (note 59(b))	74	69
	<u>3,378</u>	<u>3,452</u>
General and administrative expenses:		
- rental expenses	430	409
- amortisation of prepaid operating lease payment (note 41)	15	14
- other premises and equipment	900	926
- marketing and advertising expenses	382	516
- other operating expenses	1,021	986
	<u>2,748</u>	<u>2,851</u>
Depreciation of business premises and equipment (note 40(a))	466	432
Amortisation of intangible assets (note 42(c))	84	60
	<u>6,676</u>	<u>6,795</u>
* of which:		
share based payments (note 60(e))	101	109
Cost efficiency ratio	32.1%	29.2%

Included in operating expenses are minimum lease payments under operating leases of HK\$461 million (2008: HK\$437 million).

**NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

**18 The emoluments of the five highest paid individuals**

**(a) The aggregate emoluments**

	<b>2009</b>	2008
Salaries, allowances and benefits in kind	17	22
Retirement scheme contributions	2	3
Discretionary bonuses	10	18
Share-based payments	6	8
	<u>35</u>	<u>51</u>

**(b) The numbers of the five highest paid individuals whose emoluments fell within the following bands were:**

HK\$	<b>2009</b> <b>Number of</b> <b>Individuals</b>	2008 Number of Individuals
5,000,001 - 5,500,000	1	-
5,500,001 - 6,000,000	1	-
6,000,001 - 6,500,000	1	-
6,500,001 - 7,000,000	1	1
7,500,001 - 8,000,000	-	2
9,000,001 - 9,500,000	-	1
10,500,001 - 11,000,000	1	-
19,500,001 - 20,000,000	-	1
	<u>5</u>	<u>5</u>

The emoluments of the five highest paid individuals set out above include the emoluments of three (2008: three) Executive Directors and one non-executive director (2008: Nil). Their respective directors' emoluments are included in note 19.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 19 Directors' emoluments

The emoluments of the Directors of the Bank calculated in accordance with section 161 of the Hong Kong Companies Ordinance were:

	Fees '000	Salaries, allowances and benefits in kind '000	Pension and Pension contribution <sup>(6)</sup> '000	Discretionary Bonuses '000	Share-based payments <sup>(7)</sup> '000	Total 2009 '000	Total 2008 '000
<b>Executive Directors</b>							
Ms Margaret Leung <sup>(1)</sup> (Appointed on 6 May 09)	27	4,234	573	-	-	4,834	-
Mr William W C Leung <sup>(3)</sup> (Appointed on 7 Aug 09)	-	1,359	156	-	359	1,874	-
Mr Raymond C F Or <sup>(2)</sup> (Resigned on 6 May 09)	-	3,447	406	3,195	3,652	10,700	19,646
Mr Joseph C Y Poon <sup>(3)</sup> (Resigned on 30 Sep 09)	-	3,002	308	2,728	-	6,038	9,085
Mr Patrick K W Chan <sup>(3)</sup> (Resigned on 6 May 09)	-	1,261	104	1,476	-	2,841	6,987
<b>Non-Executive Directors</b>							
Mr Raymond K F Ch'ien <sup>(5)</sup>	360	-	-	-	-	360	360
Mr Edgar David Ancona <sup>(4)</sup> (Resigned on 31 Aug 09)	187	-	-	-	-	187	280
Mr Iain James MACKAY <sup>(4)</sup> (Appointed on 1 Sep 09)	93	-	-	-	-	93	-
Ms Dorothy K Y P Sit <sup>(3)</sup> (Appointed on 7 Aug 09)	-	1,556	155	-	380	2,091	-
Mr Alexander A Flockhart <sup>(4)</sup>	280	-	-	-	-	280	280
Mr John C C Chan <sup>(5)</sup>	340	-	-	-	-	340	340
Dr Y T Cheng <sup>(5)</sup> (Resigned on 6 May 09)	117	-	-	-	-	117	280
Dr Marvin K T Cheung <sup>(5)</sup>	360	-	-	-	-	360	360
Mr Jenkin Hui <sup>(5)</sup>	320	-	-	-	-	320	320
Mr Peter T C Lee <sup>(5)</sup> (Deceased on 17 Oct 09)	267	-	-	-	-	267	320
Dr Eric K C Li <sup>(5)</sup>	400	-	-	-	-	400	400
Dr Vincent H S Lo	280	-	-	-	-	280	280
Dr David W K Sin <sup>(5)</sup> (Resigned on 6 May 09)	117	-	-	-	-	117	280
Mr Richard Y S Tang <sup>(5)</sup>	473	-	-	-	-	473	473
Mr Peter T S Wong <sup>(4)</sup>	280	-	-	-	-	280	280
<b>Past Directors</b>	-	-	2,169	-	-	2,169	2,169
	<u>3,901</u>	<u>14,859</u>	<u>3,871</u>	<u>7,399</u>	<u>4,391</u>	<u>34,421</u>	<u>42,140</u>
2008	<u>4,253</u>	<u>15,131</u>	<u>3,848</u>	<u>13,037</u>	<u>5,871</u>		

#### Notes :

- Fee received by Mrs Margaret Leung as Non-Executive Director of the Bank for the period from 1 April 2009 to 6 May 2009 in the sum of HK\$27,616 was surrendered to The Hongkong and Shanghai Banking Corporation Limited in accordance with the HSBC Group's internal policy. No Director's fee was payable to Mrs Leung in her capacity as Executive Director of the Bank. The sums paid by the Bank to Mrs Leung as an executive of the Bank include sums paid by the Bank in respect of the period from 20 April 2009 to 5 May 2009 when Mrs Leung worked full-time at the Bank to facilitate a smooth handover before she formally took up the position of Chief Executive of the Bank on 6 May 2009.
- In line with the HSBC Group's remuneration policy, no Director's fee was paid to Mr Raymond Or during the period from 1 January 2009 to 6 May 2009. The sum paid by the Bank to Mr Raymond Or during the year include sum paid by the Bank in respect of the period from 6 May to 31 May 2009 when Mr Raymond Or, having retired from the Board and ceased to be the Bank's Chief Executive, still worked full-time at the Bank to facilitate a smooth handover to the Bank's new Chief Executive.
- Fee receivable as a Director of Hang Seng Bank Limited were waived by the Directors in 2009.
- Fees receivable as a Director of Hang Seng Bank Limited were surrendered to The Hongkong and Shanghai Banking Corporation Limited in accordance with the HSBC Group's internal policy.
- Independent Non-Executive Director.
- The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK\$2.2 million in 2009. The Bank made contributions during 2009 into the pension schemes of which the Bank's past Directors are among their members. The contributions serve to maintain the funding positions of these schemes in respect of liabilities to all scheme members, including but not limited to the past Directors. The amount of contribution attributable to any specific scheme member is not determinable.
- These represent the estimated fair value of share option granted to certain directors under the HSBC Group share option plan and the purchase cost of restricted share and performance share under the HSBC Group share plan, which is measured according to the Group's accounting policies for share-based payment as set out in note 4(y). The details of these benefits in kind are also set out in note 60.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 20 Auditors' remuneration

	Group		Bank	
	2009	2008	2009	2008
Statutory audit services	13	13	9	8
Non-statutory audit services and others	6	7	5	5
	<u>19</u>	<u>20</u>	<u>14</u>	<u>13</u>

### 21 Gains less losses from financial investments and fixed assets

	2009	2008
Net gains from disposal of available-for-sale equity securities:		
- reclassified from reserve	165	2,199
- net losses arising in the year	(4)	(1,553)
	161	646
Net losses from disposal of available-for-sale debt securities	(152)	(83)
Impairment of available-for-sale equity securities	(4)	(284)
Gains less losses on disposal of assets held for sale	187	-
Gains less losses on disposal of fixed assets	(6)	(12)
	<u>186</u>	<u>267</u>

There was no impairment losses or gains less losses on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost for 2009 and 2008.

### 22 Net surplus on property revaluation

	2009	2008
Surplus of revaluation on investment properties (note 39(a))	250	8
(Revaluation deficit)/reversal of revaluation deficit on premises (note 40(a))	(31)	71
	<u>219</u>	<u>79</u>

### 23 Tax expense

#### (a) Taxation in the consolidated income statement represents:

	2009	2008
<b>Current tax-provision for Hong Kong profits tax</b>		
Tax for the year	1,844	2,167
Adjustment in respect of prior year	(3)	(350)
	<u>1,841</u>	<u>1,817</u>
<b>Current tax-taxation outside Hong Kong</b>		
Tax for the year	50	(21)
<b>Deferred tax (note 50(b))</b>		
Origination and reversal of temporary differences	365	31
Effect of decrease in tax rate on deferred tax balances at 1 January	-	(48)
	<u>365</u>	<u>(17)</u>
<b>Total tax expense</b>	<u>2,256</u>	<u>1,779</u>

The current tax provision is based on the estimated assessable profit for 2009, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 16.5 per cent (2008: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 23 Tax expense (continued)

#### (b) Reconciliation between taxation charge and accounting profit at applicable tax rates:

	2009	2008
Profit before tax	<u>15,477</u>	<u>15,878</u>
Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2008: 16.5%)	2,554	2,620
Tax effect of:		
- different tax rates in other countries/areas	(139)	(122)
- non-taxable income and non-deductible expenses	(108)	(68)
- share of results of associates	(288)	(298)
- reduction in tax rate on deferred tax opening balance	-	(48)
- others	237	(305)
Actual charge for taxation	<u>2,256</u>	<u>1,779</u>

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### 24 Profit attributable to shareholders

Of the profit attributable to shareholders, HK\$10,341 million (2008: HK\$10,598 million) has been dealt with in the financial statements of the Bank.

Reconciliation of the above amount to the Bank's profit for the year:

	2009	2008
Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements	10,341	10,598
Dividends declared during the year by subsidiaries from retained profits	<u>5</u>	<u>232</u>
The Bank's profit for the year	<u>10,346</u>	<u>10,830</u>

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### 25 Earnings per share

The calculation of earnings per share for 2009 is based on earnings of HK\$13,221 million (HK\$14,099 million in 2008) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2008).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 26 Dividends per share

#### (a) Dividends attributable to the year:

	2009		2008	
	per share HK\$	HK\$ million	per share HK\$	HK\$ million
First interim	1.10	2,103	1.10	2,103
Second interim	1.10	2,103	1.10	2,103
Third interim	1.10	2,103	1.10	2,103
Fourth interim	1.90	3,633	3.00	5,736
	<u>5.20</u>	<u>9,942</u>	<u>6.30</u>	<u>12,045</u>

The fourth interim dividend proposed after the end of the reporting period has not been recognised as a liability at the end of the reporting period.

#### (b) Dividends attributable to the previous year, approved and paid during the year:

	2009	2008
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK\$3.00 per share (2008: HK\$3.00 per share)	<u>5,736</u>	<u>5,736</u>

### 27 Segmental analysis

The Group's business comprises five customer groups. On first-time adoption of HKFRS 8 "Operating segments" and in a manner consistent with the way in which information is reported internally for the purposes of resource allocation and performance assessment, the Group has identified the following five reportable segments.

Personal Financial Services provides banking (including deposits, credit cards, mortgages and other retail lending) and wealth management services (including private banking, investment and insurance) to personal customers. Commercial Banking manages middle market and smaller corporate relationships and specialises in trade-related financial services. Corporate Banking handles relationships with large corporate and institutional customers. Treasury engages in balance sheet management and proprietary trading. Treasury also manages the funding and liquidity positions of the Group and other market risk positions arising from banking activities. "Other" mainly represents management of shareholders' funds and investments in premises, investment properties and equity shares.

#### (a) Segment result

For the purpose of segmental analysis, the allocation of revenue reflects the benefits of capital and other funding resources allocated to the customer groups by way of internal capital allocation and fund transfer-pricing mechanisms. Cost allocation is based on the direct costs incurred by the respective customer groups and apportionment of management overheads. Rental charges at market rates for usage of premises are reflected in other operating income for the "Other" customer group and total operating expenses for the respective customer groups.



NOTES TO THE FINANCIAL STATEMENTS (continued)

27 Segmental analysis (continued)

(a) Segment result (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Total reportable segments	Inter- segment elimination	Total
<b>2009</b>								
Net interest income	8,195	2,011	1,158	2,162	497	14,023	-	14,023
Net fee income/(expense)	3,000	1,114	145	(35)	97	4,321	-	4,321
Trading income/(loss)	662	245	8	1,054	(46)	1,923	-	1,923
Net (loss)/income from financial instruments designated at fair value	(54)	-	-	5	(26)	(75)	-	(75)
Dividend income	2	6	-	-	8	16	-	16
Net earned insurance premiums	11,293	225	1	-	-	11,519	-	11,519
Other operating income	898	29	1	-	632	1,560	(471)	1,089
<b>Total operating income</b>	<b>23,996</b>	<b>3,630</b>	<b>1,313</b>	<b>3,186</b>	<b>1,162</b>	<b>33,287</b>	<b>(471)</b>	<b>32,816</b>
Net insurance claims incurred and movement in policyholders' liabilities	(11,868)	(134)	(2)	-	-	(12,004)	-	(12,004)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>12,128</b>	<b>3,496</b>	<b>1,311</b>	<b>3,186</b>	<b>1,162</b>	<b>21,283</b>	<b>(471)</b>	<b>20,812</b>
Loan impairment charges and other credit risk provisions	(454)	(278)	(78)	(2)	-	(812)	-	(812)
<b>Net operating income</b>	<b>11,674</b>	<b>3,218</b>	<b>1,233</b>	<b>3,184</b>	<b>1,162</b>	<b>20,471</b>	<b>(471)</b>	<b>20,000</b>
Total operating expenses*	(4,671)	(1,507)	(332)	(268)	(369)	(7,147)	471	(6,676)
<b>Operating profit</b>	<b>7,003</b>	<b>1,711</b>	<b>901</b>	<b>2,916</b>	<b>793</b>	<b>13,324</b>	<b>-</b>	<b>13,324</b>
Gains less losses from financial investments and fixed assets	96	53	14	(152)	175	186	-	186
Net surplus on property revaluation	-	-	-	-	219	219	-	219
Share of profits from associates	159	873	-	629	87	1,748	-	1,748
<b>Profit before tax</b>	<b>7,258</b>	<b>2,637</b>	<b>915</b>	<b>3,393</b>	<b>1,274</b>	<b>15,477</b>	<b>-</b>	<b>15,477</b>
Share of profit before tax	46.9%	17.0%	5.9%	21.9%	8.3%	100.0%	-	100.0%
Operating profit excluding loan impairment charges and other credit risk provisions	7,457	1,989	979	2,918	793	14,136	-	14,136
* Depreciation/amortisation included in total operating expenses	(173)	(31)	(7)	(4)	(335)	(550)	-	(550)
Total assets	234,723	96,490	88,135	377,561	29,059	825,968	-	825,968
Total liabilities	554,357	123,996	37,477	21,503	30,411	767,744	-	767,744
Investments in associates	847	4,284	-	2,707	2,388	10,226	-	10,226
Capital expenditure incurred	181	34	5	-	92	312	-	312

NOTES TO THE FINANCIAL STATEMENTS (continued)

27 Segmental analysis (continued)

(a) Segment result (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Total reportable segments	Inter- segment elimination	Total
2008								
Net interest income	8,700	2,411	988	2,682	1,451	16,232	-	16,232
Net fee income/(expense)	3,696	1,066	127	(33)	113	4,969	-	4,969
Trading income/(loss)	743	245	18	641	(192)	1,455	-	1,455
Net (loss)/income from financial instruments designated at fair value	(1,043)	(2)	-	(10)	24	(1,031)	-	(1,031)
Dividend income	25	10	-	-	47	82	-	82
Net earned insurance premiums	12,135	213	3	-	-	12,351	-	12,351
Other operating income	439	54	2	4	671	1,170	(469)	701
<b>Total operating income</b>	<u>24,695</u>	<u>3,997</u>	<u>1,138</u>	<u>3,284</u>	<u>2,114</u>	<u>35,228</u>	<u>(469)</u>	<u>34,759</u>
Net insurance claims incurred and movement in policyholders' liabilities	(11,349)	(113)	(1)	-	-	(11,463)	-	(11,463)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<u>13,346</u>	<u>3,884</u>	<u>1,137</u>	<u>3,284</u>	<u>2,114</u>	<u>23,765</u>	<u>(469)</u>	<u>23,296</u>
Loan impairment charges and other credit risk provisions	(347)	(853)	(201)	(1,375)	-	(2,776)	-	(2,776)
<b>Net operating income</b>	<u>12,999</u>	<u>3,031</u>	<u>936</u>	<u>1,909</u>	<u>2,114</u>	<u>20,989</u>	<u>(469)</u>	<u>20,520</u>
Total operating expenses*	(4,879)	(1,530)	(322)	(247)	(286)	(7,264)	469	(6,795)
<b>Operating profit</b>	<u>8,120</u>	<u>1,501</u>	<u>614</u>	<u>1,662</u>	<u>1,828</u>	<u>13,725</u>	<u>-</u>	<u>13,725</u>
Gains less losses from financial investments and fixed assets	156	85	31	(84)	79	267	-	267
Net surplus on property revaluation	-	-	-	-	79	79	-	79
Share of profits from associates	134	884	-	701	88	1,807	-	1,807
<b>Profit before tax</b>	<u>8,410</u>	<u>2,470</u>	<u>645</u>	<u>2,279</u>	<u>2,074</u>	<u>15,878</u>	<u>-</u>	<u>15,878</u>
Share of profit before tax	<u>52.9%</u>	<u>15.6%</u>	<u>4.1%</u>	<u>14.4%</u>	<u>13.0%</u>	<u>100.0%</u>	<u>-</u>	<u>100.0%</u>
Operating profit excluding loan impairment charges and other credit risk provisions	8,467	2,354	815	3,037	1,828	16,501	-	16,501
* Depreciation/amortisation included in total operating expenses	(140)	(24)	(7)	(3)	(318)	(492)	-	(492)
Total assets	<u>211,092</u>	<u>85,791</u>	<u>93,570</u>	<u>345,920</u>	<u>25,795</u>	<u>762,168</u>	<u>-</u>	<u>762,168</u>
Total liabilities	<u>508,596</u>	<u>96,905</u>	<u>41,981</u>	<u>34,575</u>	<u>28,485</u>	<u>710,542</u>	<u>-</u>	<u>710,542</u>
Investments in associates	<u>501</u>	<u>3,194</u>	<u>-</u>	<u>2,784</u>	<u>2,391</u>	<u>8,870</u>	<u>-</u>	<u>8,870</u>
Capital expenditure incurred	<u>374</u>	<u>52</u>	<u>14</u>	<u>3</u>	<u>223</u>	<u>666</u>	<u>-</u>	<u>666</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 27 Segmental analysis (continued)

#### (b) Geographic Information

The geographical regions in this analysis are classified by the location of the principal operations of the subsidiary companies or, in the case of the Bank itself, by the location of the branches responsible for reporting the results or advancing the funds.

	2009	%	2008	%
<b>Total operating income</b>				
- Hong Kong	30,923	94	31,381	90
- Americas	885	3	2,378	7
- Mainland and other	1,008	3	1,000	3
	<u>32,816</u>	<u>100</u>	<u>34,759</u>	<u>100</u>
<b>Profit before tax</b>				
- Hong Kong	12,902	83	12,834	81
- Americas	799	5	1,771	11
- Mainland and other	1,776	12	1,273	8
	<u>15,477</u>	<u>100</u>	<u>15,878</u>	<u>100</u>
<b>Total assets</b>				
- Hong Kong	705,467	85	656,411	86
- Americas	63,808	8	55,365	7
- Mainland and other	56,693	7	50,392	7
	<u>825,968</u>	<u>100</u>	<u>762,168</u>	<u>100</u>
<b>Total liabilities</b>				
- Hong Kong	733,842	96	680,296	96
- Americas	1,109	-	1,238	-
- Mainland and other	32,793	4	29,008	4
	<u>767,744</u>	<u>100</u>	<u>710,542</u>	<u>100</u>
<b>Interest in associates</b>				
- Hong Kong	916	9	883	10
- Americas	-	-	-	-
- Mainland and other	9,310	91	7,987	90
	<u>10,226</u>	<u>100</u>	<u>8,870</u>	<u>100</u>
<b>Non-current assets*</b>				
- Hong Kong	13,947	98	12,722	97
- Americas	-	-	-	-
- Mainland and other	317	2	346	3
	<u>14,264</u>	<u>100</u>	<u>13,068</u>	<u>100</u>
<b>Contingent liabilities and commitments</b>				
- Hong Kong	198,996	92	196,778	94
- Americas	-	-	-	-
- Mainland and other	18,038	8	13,464	6
	<u>217,034</u>	<u>100</u>	<u>210,242</u>	<u>100</u>

\* Non-current assets consist of properties, plant and equipment, goodwill and other intangible assets.

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**28 Analysis of assets and liabilities by remaining maturity**

The maturity analysis is based on the remaining period at the end of the reporting period to the contractual maturity date, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

	Group								Total
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	
<b>2009</b>									
<b>Assets</b>									
Cash and balances with banks and other financial institutions	22,086	-	-	-	-	-	-	-	22,086
Placings with and advances to banks and other financial institutions	4,352	72,226	25,557	2,416	-	-	-	-	104,551
Trading assets	-	-	-	-	-	-	66,597	-	66,597
Financial assets designated at fair value	-	-	20	646	4,201	58	-	525	5,450
Derivative financial instruments	-	7	34	232	118	-	4,659	-	5,050
Advances to customers	9,254	22,927	25,005	51,673	121,394	114,368	-	-	344,621
Financial investments:									
- available-for-sale investments	-	18,050	16,426	48,560	108,360	628	-	809	192,833
- held-to-maturity debt securities	-	31	282	1,395	21,538	25,423	-	-	48,669
Investments in associates	-	-	-	-	-	-	-	10,226	10,226
Investment properties	-	-	-	-	-	-	-	2,872	2,872
Premises, plant and equipment	-	-	-	-	-	-	-	7,178	7,178
Interest in leasehold land held for own use under operating lease	-	-	-	-	-	-	-	536	536
Intangible assets	-	-	-	-	-	-	-	4,214	4,214
Other assets	4,558	2,682	1,838	1,511	126	14	-	340	11,069
Deferred tax assets	-	-	-	-	-	-	-	16	16
	<u>40,250</u>	<u>115,923</u>	<u>69,162</u>	<u>106,433</u>	<u>255,737</u>	<u>140,491</u>	<u>71,256</u>	<u>26,716</u>	<u>825,968</u>
<b>Liabilities</b>									
Current, savings and other deposit accounts	494,026	81,129	38,108	22,427	679	-	-	-	636,369
Deposits from banks	2,964	1,737	28	25	116	-	-	-	4,870
Trading liabilities	-	-	-	-	-	-	38,391	-	38,391
Financial liabilities designated at fair value	3	-	-	1,000	-	-	-	453	1,456
Derivative financial instruments	-	-	6	21	630	13	3,581	-	4,251
Certificates of deposit and other debt securities in issue:									
- certificates of deposit in issue	-	159	171	1,177	319	-	-	-	1,826
Other liabilities	6,044	3,158	1,955	1,452	150	116	-	2,410	15,285
Liabilities to customers under insurance contracts	-	-	-	-	-	-	-	54,240	54,240
Current tax liabilities	-	-	-	52	-	-	-	-	52
Deferred tax liabilities	-	-	-	-	-	-	-	1,684	1,684
Subordinated liabilities	-	-	-	3,516	5,804	-	-	-	9,320
	<u>503,037</u>	<u>86,183</u>	<u>40,268</u>	<u>29,670</u>	<u>7,698</u>	<u>129</u>	<u>41,972</u>	<u>58,787</u>	<u>767,744</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

28 Analysis of assets and liabilities by remaining maturity (continued)

	Group								Total
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	
of which:									
Certificates of deposit included in:									
- trading assets	-	-	-	-	-	-	-	-	-
- financial assets designated at fair value	-	-	-	130	-	-	-	(1)	129
- available-for-sale investments	-	-	1,493	2,061	2,026	116	-	38	5,734
- held-to-maturity debt securities	-	-	23	161	941	806	-	-	1,931
	<u>-</u>	<u>-</u>	<u>1,516</u>	<u>2,352</u>	<u>2,967</u>	<u>922</u>	<u>-</u>	<u>37</u>	<u>7,794</u>
Debt securities included in:									
- trading assets	-	-	-	-	-	-	66,590	-	66,590
- financial assets designated at fair value	-	-	20	516	4,201	58	-	3	4,798
- available-for-sale investments	-	18,050	14,933	46,499	106,334	512	-	424	186,752
- held-to-maturity debt securities	-	31	259	1,234	20,597	24,617	-	-	46,738
	<u>-</u>	<u>18,081</u>	<u>15,212</u>	<u>48,249</u>	<u>131,132</u>	<u>25,187</u>	<u>66,590</u>	<u>427</u>	<u>304,878</u>
Certificates of deposit in issue included in:									
- trading liabilities	-	-	-	-	-	-	478	-	478
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-
- issue at amortised cost	-	159	171	1,177	319	-	-	-	1,826
	<u>-</u>	<u>159</u>	<u>171</u>	<u>1,177</u>	<u>319</u>	<u>-</u>	<u>478</u>	<u>-</u>	<u>2,304</u>

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**28 Analysis of assets and liabilities by remaining maturity** (continued)

	Group								Total
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	
2008									
<b>Assets</b>									
Cash and balances with banks and other financial institutions	24,822	-	-	-	-	-	-	-	24,822
Placings with and advances to banks and other financial institutions	6,440	40,585	15,934	6,620	-	-	-	-	69,579
Trading assets	-	-	-	-	-	-	108,389	-	108,389
Financial assets designated at fair value	-	35	91	1,052	6,004	230	-	386	7,798
Derivative financial instruments	-	129	252	744	285	-	5,694	-	7,104
Advances to customers	19,056	14,830	22,376	47,777	121,586	103,496	-	-	329,121
Financial investments:									
- available-for-sale investments	5	9,921	15,507	27,129	89,357	2,452	-	583	144,954
- held-to-maturity debt securities	-	-	211	912	12,155	22,927	-	-	36,205
Investments in associates	-	-	-	-	-	-	-	8,870	8,870
Investment properties	-	-	-	-	-	-	-	2,593	2,593
Premises, plant and equipment	-	-	-	-	-	-	-	7,090	7,090
Interest in leasehold land held for own use under operating lease	-	-	-	-	-	-	-	551	551
Intangible assets	-	-	-	-	-	-	-	3,385	3,385
Other assets	4,224	1,781	1,636	3,570	51	8	-	236	11,506
Deferred tax assets	-	-	-	-	-	-	-	201	201
	<u>54,547</u>	<u>67,281</u>	<u>56,007</u>	<u>87,804</u>	<u>229,438</u>	<u>129,113</u>	<u>114,083</u>	<u>23,895</u>	<u>762,168</u>
<b>Liabilities</b>									
Current, savings and other deposit accounts	358,976	128,083	60,146	13,916	777	285	-	-	562,183
Deposits from banks	5,712	4,274	1,279	291	-	-	-	-	11,556
Trading liabilities	-	-	-	-	-	-	48,282	-	48,282
Financial liabilities designated at fair value	3	-	-	-	998	-	-	406	1,407
Derivative financial instruments	-	1	-	5	304	259	14,376	-	14,945
Certificates of deposit and other debt securities in issue:									
- certificates of deposit in issue	-	295	-	1,082	1,395	-	-	-	2,772
Other liabilities	4,657	2,154	1,225	2,996	69	116	-	4,231	15,448
Liabilities to customers under insurance contracts	-	-	-	-	-	-	-	43,835	43,835
Current tax liabilities	-	1	-	93	-	-	-	-	94
Deferred tax liabilities	-	-	-	-	-	-	-	711	711
Subordinated liabilities	-	-	-	-	9,309	-	-	-	9,309
	<u>369,348</u>	<u>134,808</u>	<u>62,650</u>	<u>18,383</u>	<u>12,852</u>	<u>660</u>	<u>62,658</u>	<u>49,183</u>	<u>710,542</u>

**NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

**28 Analysis of assets and liabilities by remaining maturity** *(continued)*

	Group								Total
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	
of which:									
Certificates of deposit included in:									
- trading assets	-	-	-	-	-	-	-	-	-
- financial assets designated at fair value	-	-	8	15	140	-	-	-	163
- available-for-sale investments	-	400	1,661	3,964	3,804	664	-	35	10,528
- held-to-maturity debt securities	-	-	43	427	1,066	807	-	-	2,343
	<u>-</u>	<u>400</u>	<u>1,712</u>	<u>4,406</u>	<u>5,010</u>	<u>1,471</u>	<u>-</u>	<u>35</u>	<u>13,034</u>
Debt securities included in:									
- trading assets	-	-	-	-	-	-	108,371	-	108,371
- financial assets designated at fair value	-	35	83	1,037	5,864	230	-	24	7,273
- available-for-sale investments	5	9,521	13,846	23,165	85,553	1,788	-	114	133,992
- held-to-maturity debt securities	-	-	168	485	11,089	22,120	-	-	33,862
	<u>5</u>	<u>9,556</u>	<u>14,097</u>	<u>24,687</u>	<u>102,506</u>	<u>24,138</u>	<u>108,371</u>	<u>138</u>	<u>283,498</u>
Certificates of deposit in issue included in:									
- trading liabilities	-	-	-	-	-	-	3,861	-	3,861
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-
- issue at amortised cost	-	295	-	1,082	1,395	-	-	-	2,772
	<u>-</u>	<u>295</u>	<u>-</u>	<u>1,082</u>	<u>1,395</u>	<u>-</u>	<u>3,861</u>	<u>-</u>	<u>6,633</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

28 Analysis of assets and liabilities by remaining maturity (continued)

	Bank							No contractual maturity	Total
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading		
<b>2009</b>									
<b>Assets</b>									
Cash and balances with banks and other financial institutions	18,461	-	-	-	-	-	-	-	18,461
Placings with and advances to banks and other financial institutions	1,326	45,657	17,809	832	-	-	-	-	65,624
Trading assets	-	-	-	-	-	-	65,288	-	65,288
Financial assets designated at fair value	-	-	-	20	144	-	-	10	174
Derivative financial instruments	-	7	24	227	101	-	4,557	-	4,916
Advances to customers	9,248	20,461	20,035	42,646	105,426	101,363	-	-	299,179
Amounts due from subsidiaries	61,771	1,783	18,373	3,449	1,984	-	-	-	87,360
Financial investments:									
- available-for-sale investments	-	15,619	11,365	39,353	89,143	629	-	606	156,715
Investments in subsidiaries	-	-	-	-	-	-	-	11,584	11,584
Investments in associates	-	-	-	-	-	-	-	2,546	2,546
Investment properties	-	-	-	-	-	-	-	1,883	1,883
Premises, plant and equipment	-	-	-	-	-	-	-	4,198	4,198
Interest in leasehold land held for own use under operating lease	-	-	-	-	-	-	-	536	536
Intangible assets	-	-	-	-	-	-	-	399	399
Other assets	4,464	2,210	1,013	389	74	-	-	86	8,236
Deferred tax assets	-	-	-	-	-	-	-	2	2
	<u>95,270</u>	<u>85,737</u>	<u>68,619</u>	<u>86,916</u>	<u>196,872</u>	<u>101,992</u>	<u>69,845</u>	<u>21,850</u>	<u>727,101</u>
<b>Liabilities</b>									
Current, savings and other deposit accounts	485,929	78,600	33,958	13,177	350	-	-	-	612,014
Deposits from banks	2,963	1,337	28	25	116	-	-	-	4,469
Trading liabilities	-	-	-	-	-	-	35,071	-	35,071
Financial liabilities designated at fair value	-	-	-	1,000	-	-	-	3	1,003
Derivative financial instruments	-	-	6	21	568	13	3,572	-	4,180
Certificates of deposit and other debt securities in issue:									
- certificates of deposit in issue	-	159	171	1,177	319	-	-	-	1,826
Amounts due to subsidiaries	4,749	4,974	237	-	-	-	-	-	9,960
Other liabilities	5,834	3,046	1,431	708	82	17	-	3,215	14,333
Current tax liabilities	-	-	-	10	-	-	-	-	10
Deferred tax liabilities	-	-	-	-	-	-	-	569	569
Subordinated liabilities	-	-	-	3,516	5,804	-	-	-	9,320
	<u>499,475</u>	<u>88,116</u>	<u>35,831</u>	<u>19,634</u>	<u>7,239</u>	<u>30</u>	<u>38,643</u>	<u>3,787</u>	<u>692,755</u>



NOTES TO THE FINANCIAL STATEMENTS (continued)

28 Analysis of assets and liabilities by remaining maturity (continued)

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
of which:									
Certificates of deposit included in:									
- trading assets	-	-	-	-	-	-	-	-	-
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-
- available-for-sale investments	-	-	621	1,194	1,158	116	-	37	3,126
- held-to-maturity debt securities	-	-	-	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>621</u>	<u>1,194</u>	<u>1,158</u>	<u>116</u>	<u>-</u>	<u>37</u>	<u>3,126</u>
Debt securities included in:									
- trading assets	-	-	-	-	-	-	65,281	-	65,281
- financial assets designated at fair value	-	-	-	20	144	-	-	10	174
- available-for-sale investments	-	15,619	10,744	38,159	87,985	513	-	422	153,442
- held-to-maturity debt securities	-	-	-	-	-	-	-	-	-
	<u>-</u>	<u>15,619</u>	<u>10,744</u>	<u>38,179</u>	<u>88,129</u>	<u>513</u>	<u>65,281</u>	<u>432</u>	<u>218,897</u>
Certificates of deposit in issue included in:									
- trading liabilities	-	-	-	-	-	-	478	-	478
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-
- issue at amortised cost	-	159	171	1,177	319	-	-	-	1,826
	<u>-</u>	<u>159</u>	<u>171</u>	<u>1,177</u>	<u>319</u>	<u>-</u>	<u>478</u>	<u>-</u>	<u>2,304</u>

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**28 Analysis of assets and liabilities by remaining maturity** (continued)

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2008									
<b>Assets</b>									
Cash and balances with banks and other financial institutions	22,071	-	-	-	-	-	-	-	22,071
Placings with and advances to banks and other financial institutions	1,197	22,579	8,840	5,481	-	-	-	-	38,097
Trading assets	-	-	-	-	-	-	107,775	-	107,775
Financial assets designated at fair value	-	-	-	639	166	-	-	25	830
Derivative financial instruments	-	80	215	647	268	-	5,700	-	6,910
Advances to customers	18,610	12,528	18,378	37,867	104,217	88,655	-	-	280,255
Amounts due from subsidiaries	55,961	2,585	22,461	2,269	1,631	-	-	-	84,907
Financial investments:									
- available-for-sale investments	5	5,566	10,928	22,112	70,514	2,452	-	423	112,000
Investments in subsidiaries	-	-	-	-	-	-	-	11,284	11,284
Investments in associates	-	-	-	-	-	-	-	2,543	2,543
Investment properties	-	-	-	-	-	-	-	1,714	1,714
Premises, plant and equipment	-	-	-	-	-	-	-	4,294	4,294
Interest in leasehold land held for own use under operating lease	-	-	-	-	-	-	-	551	551
Intangible assets	-	-	-	-	-	-	-	342	342
Other assets	4,057	948	992	2,841	4	-	-	30	8,872
Deferred tax assets	-	-	-	-	-	-	-	187	187
	<u>101,901</u>	<u>44,286</u>	<u>61,814</u>	<u>71,856</u>	<u>176,800</u>	<u>91,107</u>	<u>113,475</u>	<u>21,393</u>	<u>682,632</u>
<b>Liabilities</b>									
Current, savings and other deposit accounts	354,184	126,950	54,895	10,948	123	285	-	-	547,385
Deposits from banks	5,712	1,829	722	-	-	-	-	-	8,263
Trading liabilities	-	-	-	-	-	-	43,467	-	43,467
Financial liabilities designated at fair value	-	-	-	-	998	-	-	(4)	994
Derivative financial instruments	-	2	-	5	297	258	14,376	-	14,938
Certificates of deposit and other debt securities in issue:									
- certificates of deposit in issue	-	295	-	1,082	1,395	-	-	-	2,772
Amounts due to subsidiaries	3,532	5,023	20	-	-	-	-	-	8,575
Other liabilities	4,485	1,823	922	2,533	-	17	-	5,030	14,810
Current tax liabilities	-	-	-	66	-	-	-	-	66
Deferred tax liabilities	-	-	-	-	-	-	-	-	-
Subordinated liabilities	-	-	-	-	9,309	-	-	-	9,309
	<u>367,913</u>	<u>135,922</u>	<u>56,559</u>	<u>14,634</u>	<u>12,122</u>	<u>560</u>	<u>57,843</u>	<u>5,026</u>	<u>650,579</u>

**NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

**28 Analysis of assets and liabilities by remaining maturity** *(continued)*

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
of which:									
Certificates of deposit included in:									
- trading assets	-	-	-	-	-	-	-	-	-
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-
- available-for-sale investments	-	400	1,661	3,413	1,790	664	-	35	7,963
- held-to-maturity debt securities	-	-	-	-	-	-	-	-	-
	<u>-</u>	<u>400</u>	<u>1,661</u>	<u>3,413</u>	<u>1,790</u>	<u>664</u>	<u>-</u>	<u>35</u>	<u>7,963</u>
Debt securities included in:									
- trading assets	-	-	-	-	-	-	107,757	-	107,757
- financial assets designated at fair value	-	-	-	639	166	-	-	25	830
- available-for-sale investments	5	5,166	9,267	18,699	68,724	1,788	-	114	103,763
- held-to-maturity debt securities	-	-	-	-	-	-	-	-	-
	<u>5</u>	<u>5,166</u>	<u>9,267</u>	<u>19,338</u>	<u>68,890</u>	<u>1,788</u>	<u>107,757</u>	<u>139</u>	<u>212,350</u>
Certificates of deposit in issue included in:									
- trading liabilities	-	-	-	-	-	-	3,861	-	3,861
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-
- issue at amortised cost	-	295	-	1,082	1,395	-	-	-	2,772
	<u>-</u>	<u>295</u>	<u>-</u>	<u>1,082</u>	<u>1,395</u>	<u>-</u>	<u>3,861</u>	<u>-</u>	<u>6,633</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 29 Accounting classifications

The tables below set out the Group's classification of financial assets and liabilities:

	Group					Other amortised cost	Total
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables		
<b>2009</b>							
Cash and balances with banks and other financial institutions	-	-	-	-	-	22,086	22,086
Placings with and advances to banks and other financial institutions	-	-	-	-	104,551	-	104,551
Derivative financial instruments	4,641	18	391	-	-	-	5,050
Advances to customers	-	-	-	-	344,621	-	344,621
Investment securities	66,596	5,450	192,833	48,669	-	-	313,548
Acceptances and endorsements	-	-	-	-	-	3,584	3,584
Other financial assets	1	-	-	-	-	7,142	7,143
Total financial assets	<u>71,238</u>	<u>5,468</u>	<u>193,224</u>	<u>48,669</u>	<u>449,172</u>	<u>32,812</u>	<u>800,583</u>
Non-financial assets							25,385
<b>Total assets</b>							<u>825,968</u>
Current, savings and other deposit accounts	22,212	-	-	-	-	636,369	658,581
Deposits from banks	-	-	-	-	-	4,870	4,870
Derivative financial instruments	3,568	13	670	-	-	-	4,251
Certificates of deposit and other debt securities in issue	3,247	-	-	-	-	1,826	5,073
Other financial liabilities	12,932	-	-	-	-	8,221	21,153
Subordinated liabilities	-	1,003	-	-	-	9,320	10,323
Liabilities to customers under investment contracts	-	453	-	-	-	-	453
Acceptances and endorsements	-	-	-	-	-	3,584	3,584
Total financial liabilities	<u>41,959</u>	<u>1,469</u>	<u>670</u>	<u>-</u>	<u>-</u>	<u>664,190</u>	<u>708,288</u>
Non-financial liabilities							59,456
<b>Total liabilities</b>							<u>767,744</u>

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**29 Accounting classifications** (continued)

	Group						Total
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	
2008							
Cash and balances with banks and other financial institutions	-	-	-	-	-	24,822	24,822
Placings with and advances to banks and other financial institutions	-	-	-	-	69,579	-	69,579
Derivative financial instruments	5,663	31	1,410	-	-	-	7,104
Advances to customers	-	-	-	-	329,121	-	329,121
Investment securities	108,371	7,798	144,954	36,205	-	-	297,328
Acceptances and endorsements	-	-	-	-	-	3,090	3,090
Other financial assets	18	-	-	-	-	8,033	8,051
Total financial assets	<u>114,052</u>	<u>7,829</u>	<u>146,364</u>	<u>36,205</u>	<u>398,700</u>	<u>35,945</u>	<u>739,095</u>
Non-financial assets							<u>23,073</u>
<b>Total assets</b>							<u><u>762,168</u></u>
Current, savings and other deposit accounts	29,785	-	-	-	-	562,183	591,968
Deposits from banks	-	-	-	-	-	11,556	11,556
Derivative financial instruments	14,346	30	569	-	-	-	14,945
Certificates of deposit and other debt securities in issue	9,716	-	-	-	-	2,772	12,488
Other financial liabilities	8,781	-	-	-	-	6,997	15,778
Subordinated liabilities	-	994	-	-	-	9,309	10,303
Liabilities to customers under investment contracts	-	413	-	-	-	-	413
Acceptances and endorsements	-	-	-	-	-	3,090	3,090
Total financial liabilities	<u>62,628</u>	<u>1,437</u>	<u>569</u>	<u>-</u>	<u>-</u>	<u>595,907</u>	<u>660,541</u>
Non-financial liabilities							<u>50,001</u>
<b>Total liabilities</b>							<u><u>710,542</u></u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

29 Accounting classifications (continued)

	Bank						
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	Total
<b>2009</b>							
Cash and balances with banks and other financial institutions	-	-	-	-	-	18,461	18,461
Placings with and advances to banks and other financial institutions	-	-	-	-	65,624	-	65,624
Derivative financial instruments	4,540	17	359	-	-	-	4,916
Advances to customers	-	-	-	-	299,179	-	299,179
Investment securities	65,287	174	156,715	-	-	-	222,176
Amounts due from subsidiaries	-	-	-	-	-	87,360	87,360
Acceptances and endorsements	-	-	-	-	-	2,435	2,435
Other financial assets	1	-	-	-	-	5,605	5,606
Total financial assets	<u>69,828</u>	<u>191</u>	<u>157,074</u>	<u>-</u>	<u>364,803</u>	<u>113,861</u>	<u>705,757</u>
Non-financial assets							21,344
<b>Total assets</b>							<u><u>727,101</u></u>
Current, savings and other deposit accounts	18,892	-	-	-	-	612,014	630,906
Deposits from banks	-	-	-	-	-	4,469	4,469
Derivative financial instruments	3,559	13	608	-	-	-	4,180
Certificates of deposit and other debt securities in issue	3,247	-	-	-	-	1,826	5,073
Amounts due to subsidiaries	-	-	-	-	-	9,960	9,960
Other financial liabilities	12,932	-	-	-	-	8,677	21,609
Subordinated liabilities	-	1,003	-	-	-	9,320	10,323
Acceptances and endorsements	-	-	-	-	-	2,435	2,435
Total financial liabilities	<u>38,630</u>	<u>1,016</u>	<u>608</u>	<u>-</u>	<u>-</u>	<u>648,701</u>	<u>688,955</u>
Non-financial liabilities							3,800
<b>Total liabilities</b>							<u><u>692,755</u></u>

**NOTES TO THE FINANCIAL STATEMENTS** *(continued)*

**29 Accounting classifications** *(continued)*

	Bank						Total
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	
2008							
Cash and balances with banks and other financial institutions	-	-	-	-	-	22,071	22,071
Placings with and advances to banks and other financial institutions	-	-	-	-	38,097	-	38,097
Derivative financial instruments	5,669	31	1,210	-	-	-	6,910
Advances to customers	-	-	-	-	280,255	-	280,255
Investment securities	107,757	830	112,000	-	-	-	220,587
Amounts due from subsidiaries	-	-	-	-	-	84,907	84,907
Acceptances and endorsements	-	-	-	-	-	2,255	2,255
Other financial assets	18	-	-	-	-	6,372	6,390
Total financial assets	<u>113,444</u>	<u>861</u>	<u>113,210</u>	<u>-</u>	<u>318,352</u>	<u>115,605</u>	<u>661,472</u>
Non-financial assets							21,160
<b>Total assets</b>							<u><u>682,632</u></u>
Current, savings and other deposit accounts	24,970	-	-	-	-	547,385	572,355
Deposits from banks	-	-	-	-	-	8,263	8,263
Derivative financial instruments	14,346	30	562	-	-	-	14,938
Certificates of deposit and other debt securities in issue	9,716	-	-	-	-	2,772	12,488
Amounts due to subsidiaries	-	-	-	-	-	8,575	8,575
Other financial liabilities	8,781	-	-	-	-	7,438	16,219
Subordinated liabilities	-	994	-	-	-	9,309	10,303
Acceptances and endorsements	-	-	-	-	-	2,255	2,255
Total financial liabilities	<u>57,813</u>	<u>1,024</u>	<u>562</u>	<u>-</u>	<u>-</u>	<u>585,997</u>	<u>645,396</u>
Non-financial liabilities							5,183
<b>Total liabilities</b>							<u><u>650,579</u></u>

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 30 Cash and balances with banks and other financial institutions

	Group		Bank	
	2009	2008	2009	2008
Cash in hand	4,299	3,696	4,079	3,488
Balances with central banks	3,397	2,426	924	896
Balances with banks and other financial institutions	14,390	18,700	13,458	17,687
	<u>22,086</u>	<u>24,822</u>	<u>18,461</u>	<u>22,071</u>

### 31 Placings with and advances to banks and other financial institutions

	Group		Bank	
	2009	2008	2009	2008
Placings with and advances to banks and other financial institutions maturing within one month	76,579	47,025	46,984	23,776
Placings with and advances to banks and other financial institutions maturing after one month but less than one year	27,972	22,554	18,640	14,321
Placings with and advances to banks and other financial institutions maturing after one year	-	-	-	-
	<u>104,551</u>	<u>69,579</u>	<u>65,624</u>	<u>38,097</u>

There were no overdue advances, impaired advances and rescheduled advances to banks and other financial institutions at 31 December 2009 by the Group and the Bank. (2008: Nil).



NOTES TO THE FINANCIAL STATEMENTS (continued)

32 Trading assets

	Group		Bank	
	2009	2008	2009	2008
Treasury bills	62,028	103,621	62,028	103,463
Certificates of deposit	-	-	-	-
Other debt securities	4,562	4,750	3,253	4,294
Debt securities	66,590	108,371	65,281	107,757
Equity shares	6	-	6	-
<b>Total trading securities</b>	<b>66,596</b>	<b>108,371</b>	<b>65,287</b>	<b>107,757</b>
Other*	1	18	1	18
<b>Total trading assets</b>	<b>66,597</b>	<b>108,389</b>	<b>65,288</b>	<b>107,775</b>
<b>Debt securities:</b>				
- listed in Hong Kong	2,712	3,631	2,712	3,631
- listed outside Hong Kong	157	269	157	269
	2,869	3,900	2,869	3,900
- unlisted	63,721	104,471	62,412	103,857
	66,590	108,371	65,281	107,757
<b>Equity shares:</b>				
- listed in Hong Kong	6	-	6	-
- unlisted	-	-	-	-
	6	-	6	-
<b>Total trading securities</b>	<b>66,596</b>	<b>108,371</b>	<b>65,287</b>	<b>107,757</b>
<b>Debt securities</b>				
Issued by public bodies:				
- central governments and central banks	65,817	107,428	64,508	106,814
- other public sector entities	369	378	369	378
	66,186	107,806	64,877	107,192
Issued by other bodies:				
- banks and other financial institutions	292	306	292	306
- corporate entities	112	259	112	259
	404	565	404	565
	66,590	108,371	65,281	107,757
<b>Equity shares</b>				
Issued by corporate entities	6	-	6	-
<b>Total trading securities</b>	<b>66,596</b>	<b>108,371</b>	<b>65,287</b>	<b>107,757</b>

\* This represents amount receivable from counterparties on trading transactions not yet settled.

NOTES TO THE FINANCIAL STATEMENTS (continued)

33 Financial assets designated at fair value

	Group		Bank	
	2009	2008	2009	2008
Certificates of deposit	129	163	-	-
Other debt securities	4,798	7,273	174	830
Debt securities	4,927	7,436	174	830
Equity shares	523	362	-	-
	<u>5,450</u>	<u>7,798</u>	<u>174</u>	<u>830</u>
<b>Debt securities:</b>				
- listed in Hong Kong	3	834	-	449
- listed outside Hong Kong	194	1,004	154	276
	197	1,838	154	725
- unlisted	4,730	5,598	20	105
	<u>4,927</u>	<u>7,436</u>	<u>174</u>	<u>830</u>
<b>Equity shares:</b>				
- listed in Hong Kong	21	26	-	-
- listed outside Hong Kong	69	57	-	-
	90	83	-	-
- unlisted	433	279	-	-
	<u>523</u>	<u>362</u>	<u>-</u>	<u>-</u>
	<u>5,450</u>	<u>7,798</u>	<u>174</u>	<u>830</u>
<b>Debt securities</b>				
Issued by public bodies:				
- central governments and central banks	154	924	154	517
- other public sector entities	168	564	-	226
	322	1,488	154	743
Issued by other bodies:				
- banks and other financial institutions	4,464	5,317	-	65
- corporate entities	141	631	20	22
	4,605	5,948	20	87
	4,927	7,436	174	830
<b>Equity shares</b>				
Issued by corporate entities	523	362	-	-
	<u>5,450</u>	<u>7,798</u>	<u>174</u>	<u>830</u>

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 34 Derivative financial instruments

Derivatives are financial contracts whose values and characteristics are derived from underlying assets, exchange and interest rates, and indices. Derivative instruments are subject to both credit risk and market risk. The credit risk relating to a derivative contract is principally the replacement cost of the contract when it has a positive mark-to-market value and the estimated potential future change in value over the residual maturity of the contract. The nominal value of the contracts does not represent the amount of the Group's exposure to credit risk. All activities relating to derivatives are subject to the same credit approval and monitoring procedures used for other credit transactions. Market risk from derivative positions is controlled individually and in combination with on-balance sheet market risk positions within the Group's market risk limits regime as described in note 62(c).

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative financial instruments are held for trading, or financial instruments designated at fair value, or designated as either fair value hedge or cash flow hedge. The Group primarily traded over-the-counter derivatives and also participated in exchange traded derivatives.

#### Trading derivatives

Most of the Group's trading 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 derivatives also include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

#### 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 optimise the cost of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

##### (a) Fair value hedge

The Group's fair value hedge principally consists of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 34 Derivative financial instruments (continued)

#### (b) Cash flow hedge

The Group is exposed 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 for financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedge of forecast transactions.

Gains and losses are initially recognised in equity, in the cash flow hedge reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2009, the amount of cash flow hedge reserve transferred to the income statement comprised HK\$848 million (2008: HK\$376 million) included in net interest income and HK\$16 million (2008: HK\$1 million) included in net trading income.

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2009 and 2008. During the year of 2009, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur (2008: Nil). A gain of HK\$16 million for 2009 (2008: Nil) was recognised due to termination of such forecast transactions.

The schedules of forecast principal balances on which the expected interest cash flows associated with derivatives that are cash flow hedge were as follows:

	Group		
	Three months or less	Over three months but within one year	Over one year but within five years
<b>At 31 December 2009</b>			
Cash inflows from assets	45,526	39,564	20,587
Cash outflows from liabilities	-	-	-
Net cash inflows	<u>45,526</u>	<u>39,564</u>	<u>20,587</u>
At 31 December 2008			
Cash inflows from assets	73,395	52,855	12,844
Cash outflows from liabilities	-	-	-
Net cash inflows	<u>73,395</u>	<u>52,855</u>	<u>12,844</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 34 Derivative financial instruments (continued)

- (c) The following table shows the nominal contract amounts and marked-to-market value of assets and liabilities by each class of derivatives.

	Group					
	2009			2008		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
<b>Derivatives held for trading</b>						
Exchange rate contracts:						
- spot and forward foreign exchange	382,260	2,289	608	570,950	2,676	5,144
- currency swaps	20,837	261	132	18,356	337	229
- currency options purchased	30,561	83	-	32,729	287	-
- currency options written	40,105	-	197	33,601	-	340
- other exchange rate contracts	226	3	1	141	-	4
	<u>473,989</u>	<u>2,636</u>	<u>938</u>	<u>655,777</u>	<u>3,300</u>	<u>5,717</u>
Interest rate contracts:						
- interest rate swaps	162,662	1,552	1,622	161,018	2,120	2,249
- interest rate options purchased	143	-	-	142	-	-
- interest rate options written	142	-	-	142	-	-
- other interest rate contracts	407	-	1	217	1	-
	<u>163,354</u>	<u>1,552</u>	<u>1,623</u>	<u>161,519</u>	<u>2,121</u>	<u>2,249</u>
Equity and other contracts:						
- equity swaps	5,706	29	994	13,025	1	6,271
- equity options purchased	1,705	91	-	2,680	113	-
- equity options written	1,317	-	13	2,770	-	100
- other equity contracts	6	-	-	8	-	-
- spot and forward contracts and other	2,651	333	-	2,685	128	9
	<u>11,385</u>	<u>453</u>	<u>1,007</u>	<u>21,168</u>	<u>242</u>	<u>6,380</u>
Total derivatives held for trading	<u>648,728</u>	<u>4,641</u>	<u>3,568</u>	<u>838,464</u>	<u>5,663</u>	<u>14,346</u>
<b>Derivatives embedded in financial assets designated at fair value</b>						
Exchange rate contracts:						
- spot and forward foreign exchange	89	1	-	-	-	-
Interest rate contracts:						
- interest rate swaps	1,160	17	13	1,797	31	30
	<u>1,249</u>	<u>18</u>	<u>13</u>	<u>1,797</u>	<u>31</u>	<u>30</u>
<b>Cash flow hedge derivatives</b>						
Interest rate contracts:						
- interest rate swaps	45,526	366	13	73,394	1,410	14
<b>Fair value hedge derivatives</b>						
Interest rate contracts:						
- interest rate swaps	21,028	25	657	12,548	-	555
<b>Total derivatives</b>	<u>716,531</u>	<u>5,050</u>	<u>4,251</u>	<u>926,203</u>	<u>7,104</u>	<u>14,945</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 34 Derivative financial instruments (continued)

	Bank					
	2009			2008		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
<b>Derivatives held for trading</b>						
Exchange rate contracts:						
- spot and forward foreign exchange	381,799	2,275	602	567,613	2,621	5,145
- currency swaps	20,837	260	132	18,356	337	229
- currency options purchased	30,606	83	-	32,735	287	-
- currency options written	40,105	-	199	33,601	-	356
- other exchange rate contracts	226	3	1	141	-	4
	<u>473,573</u>	<u>2,621</u>	<u>934</u>	<u>652,446</u>	<u>3,245</u>	<u>5,734</u>
Interest rate contracts:						
- interest rate swaps	166,030	1,543	1,612	160,254	2,119	2,232
- interest rate options purchased	143	-	-	142	-	-
- interest rate options written	142	-	-	142	-	-
- other interest rate contracts	407	-	1	217	1	-
	<u>166,722</u>	<u>1,543</u>	<u>1,613</u>	<u>160,755</u>	<u>2,120</u>	<u>2,232</u>
Equity and other contracts:						
- equity swaps	7,366	29	998	14,097	62	6,271
- equity options purchased	1,296	13	-	2,680	114	-
- equity options written	1,317	-	13	2,770	-	100
- other equity contracts	6	-	-	8	-	-
- spot and forward contracts and other	2,808	334	1	2,685	128	9
	<u>12,793</u>	<u>376</u>	<u>1,012</u>	<u>22,240</u>	<u>304</u>	<u>6,380</u>
Total derivatives held for trading	<u>653,088</u>	<u>4,540</u>	<u>3,559</u>	<u>835,441</u>	<u>5,669</u>	<u>14,346</u>
<b>Derivatives embedded in financial assets designated at fair value</b>						
Interest rate contracts:						
- interest rate swaps	<u>1,160</u>	<u>17</u>	<u>13</u>	<u>1,797</u>	<u>31</u>	<u>30</u>
<b>Cash flow hedge derivatives</b>						
Interest rate contracts:						
- interest rate swaps	<u>43,898</u>	<u>351</u>	<u>13</u>	<u>68,165</u>	<u>1,210</u>	<u>14</u>
<b>Fair value hedge derivatives</b>						
Interest rate contracts:						
- interest rate swaps	<u>16,634</u>	<u>8</u>	<u>595</u>	<u>12,428</u>	<u>-</u>	<u>548</u>
<b>Total derivatives</b>	<u>714,780</u>	<u>4,916</u>	<u>4,180</u>	<u>917,831</u>	<u>6,910</u>	<u>14,938</u>

The above derivative assets and liabilities, being the positive or negative marked-to-market value of the respective derivative contracts, represent gross replacement costs, as none of these contracts are subject to any bilateral netting arrangements.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 34 Derivative financial instruments (continued)

#### (d) Contract amounts, credit equivalent amounts and risk-weighted amounts

The table below gives the contract amounts, credit equivalent amounts and risk-weighted amounts of derivatives. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

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

The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Banking (Capital) Rules ("the Capital Rules") and depend on the status of the counterparty and maturity characteristics of the instrument.

The netting adjustments represent amounts where the Group has in place legally enforceable rights of offset with individual counterparties to offset the gross amount of positive marked-to-market assets with any negative marked-to-market liabilities with the same customer. These offsets are recognised by the HKMA in the calculation of risk assets for the capital adequacy ratio.

With the Capital Rules effective from 1 January 2007, the Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2009 were calculated based on the advanced internal ratings-based approach and the risk-weighted assets for 2008 were calculated based on the foundation internal ratings-based approach.

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
<b>2009</b>						
Exchange rate contracts:						
- spot and forward foreign exchange	334,133	5,573	689	332,869	5,546	649
- currency swaps	20,837	1,090	250	20,837	1,090	250
- currency options purchased	30,561	548	239	30,591	549	239
- other exchange rate contracts	226	6	-	226	6	-
	<u>385,757</u>	<u>7,217</u>	<u>1,178</u>	<u>384,523</u>	<u>7,191</u>	<u>1,138</u>
Interest rate contracts:						
- interest rate swaps	230,376	2,640	413	221,751	2,575	396
- interest rate options purchased	143	-	-	143	-	-
- other interest rate contracts	-	-	-	-	-	-
	<u>230,519</u>	<u>2,640</u>	<u>413</u>	<u>221,894</u>	<u>2,575</u>	<u>396</u>
Equity and other contracts:						
- equity swaps	5,706	383	31	5,706	383	31
- equity options purchased	1,296	91	61	1,296	91	61
- other equity contracts	-	-	-	-	-	-
	<u>7,002</u>	<u>474</u>	<u>92</u>	<u>7,002</u>	<u>474</u>	<u>92</u>

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 34 Derivative financial instruments *(continued)*

#### (d) Contract amounts, credit equivalent amounts and risk-weighted amounts *(continued)*

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2008						
Exchange rate contracts:						
- spot and forward foreign exchange	500,166	7,364	1,872	497,408	7,277	1,823
- currency swaps	18,356	1,185	324	18,356	1,185	324
- currency options purchased	32,729	649	454	32,729	649	454
- other exchange rate contracts	141	2	-	141	2	-
	<u>551,392</u>	<u>9,200</u>	<u>2,650</u>	<u>548,634</u>	<u>9,113</u>	<u>2,601</u>
Interest rate contracts:						
- interest rate swaps	248,758	4,144	1,117	242,583	3,940	1,083
- interest rate options purchased	142	1	-	152	1	-
- other interest rate contracts	-	-	-	-	-	-
	<u>248,900</u>	<u>4,145</u>	<u>1,117</u>	<u>242,735</u>	<u>3,941</u>	<u>1,083</u>
Equity and other contracts:						
- equity swaps	13,025	867	149	13,025	867	149
- equity options purchased	2,680	274	194	2,680	274	194
- other equity contracts	-	-	-	-	-	-
	<u>15,705</u>	<u>1,141</u>	<u>343</u>	<u>15,705</u>	<u>1,141</u>	<u>343</u>



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 35 Advances to customers

#### (a) Advances to customers

	Group		Bank	
	2009	2008	2009	2008
Gross advances to customers	<b>346,586</b>	331,164	<b>300,842</b>	281,996
Less: loan impairment allowances				
- individually assessed	<b>(1,151)</b>	(1,241)	<b>(957)</b>	(1,046)
- collectively assessed	<b>(814)</b>	(802)	<b>(706)</b>	(695)
	<b><u>344,621</u></b>	<u>329,121</u>	<b><u>299,179</u></b>	<u>280,255</u>
Included in advances to customers are:				
Trade bills	<b>2,802</b>	2,899	<b>2,504</b>	2,806
Less: loan impairment allowances	<b>(42)</b>	(30)	<b>(42)</b>	(30)
	<b><u>2,760</u></b>	<u>2,869</u>	<b><u>2,462</u></b>	<u>2,776</u>

Total loan impairment allowances as a percentage of gross advances to customers are as follows:

	Group		Bank	
	2009 %	2008 %	2009 %	2008 %
Loan impairment allowances:				
- individually assessed	<b>0.33</b>	0.37	<b>0.32</b>	0.37
- collectively assessed	<b>0.23</b>	0.24	<b>0.23</b>	0.25
Total loan impairment allowances	<b><u>0.56</u></b>	<u>0.61</u>	<b><u>0.55</u></b>	<u>0.62</u>

#### (b) Loan impairment allowances against advances to customers

	Group		
	Individually assessed	Collectively assessed	Total
<b>2009</b>			
At 1 January	<b>1,241</b>	<b>802</b>	<b>2,043</b>
Amounts written off	<b>(394)</b>	<b>(526)</b>	<b>(920)</b>
Recoveries of advances written off in previous years	<b>24</b>	<b>38</b>	<b>62</b>
New impairment allowances charged			
to income statement (note 16)	<b>564</b>	<b>540</b>	<b>1,104</b>
Impairment allowances released to income statement (note 16)	<b>(254)</b>	<b>(38)</b>	<b>(292)</b>
Unwinding of discount of loan impairment allowances recognised as "interest income"	<b>(30)</b>	<b>(2)</b>	<b>(32)</b>
At 31 December	<b><u>1,151</u></b>	<b><u>814</u></b>	<b><u>1,965</u></b>
<b>2008</b>			
At 1 January	417	636	1,053
Amounts written off	(110)	(346)	(456)
Recoveries of advances written off in previous years	20	36	56
New impairment allowances charged			
to income statement (note 16)	993	512	1,505
Impairment allowances released to income statement (note 16)	(68)	(36)	(104)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(11)	-	(11)
At 31 December	<u>1,241</u>	<u>802</u>	<u>2,043</u>

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 35 Advances to customers *(continued)*

#### (b) Loan impairment allowances against advances to customers *(continued)*

	<b>Bank</b>		
	<b>Individually assessed</b>	<b>Collectively assessed</b>	<b>Total</b>
<b>2009</b>			
At 1 January	1,046	695	1,741
Amounts written off	(349)	(526)	(875)
Recoveries of advances written off in previous years	9	37	46
New impairment allowances charged to income statement (note 16)	488	540	1,028
Impairment allowances released to income statement (note 16)	(203)	(37)	(240)
Other movement	(16)	-	(16)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(18)	(3)	(21)
At 31 December	<u>957</u>	<u>706</u>	<u>1,663</u>
<b>2008</b>			
At 1 January	330	627	957
Amounts written off	(91)	(346)	(437)
Recoveries of advances written off in previous years	7	36	43
New impairment allowances charged to income statement (note 16)	858	414	1,272
Impairment allowances released to income statement (note 16)	(50)	(36)	(86)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(8)	-	(8)
At 31 December	<u>1,046</u>	<u>695</u>	<u>1,741</u>

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 35 Advances to customers *(continued)*

#### (c) Impaired advances and allowances

	Group		Bank	
	2009	2008	2009	2008
Gross impaired advances	2,508	3,404	1,761	2,032
Individually assessed allowances	<u>(1,151)</u>	<u>(1,241)</u>	<u>(957)</u>	<u>(1,046)</u>
Net impaired advances	<u>1,357</u>	<u>2,163</u>	<u>804</u>	<u>986</u>
Individually assessed allowances as a percentage of gross impaired advances	<u>45.9%</u>	<u>36.5%</u>	<u>54.3%</u>	<u>51.5%</u>
Gross impaired advances as a percentage of gross advances to customers	<u>0.7%</u>	<u>1.0%</u>	<u>0.6%</u>	<u>0.7%</u>

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

	Group		Bank	
	2009	2008	2009	2008
Gross individually assessed impaired advances	2,434	3,297	1,687	1,925
Individually assessed allowances	<u>(1,151)</u>	<u>(1,241)</u>	<u>(957)</u>	<u>(1,046)</u>
	<u>1,283</u>	<u>2,056</u>	<u>730</u>	<u>879</u>
Gross individually assessed impaired advances as a percentage of gross advances to customers	<u>0.7%</u>	<u>1.0%</u>	<u>0.6%</u>	<u>0.7%</u>
Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers	<u>1,024</u>	<u>1,502</u>	<u>569</u>	<u>1,102</u>

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

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 35 Advances to customers (continued)

#### (d) Overdue advances

Advances to customers that are more than three months overdue and their expression as a percentage of gross advances to customers are as follows:

2009	Group	%	Bank	%
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	241	0.1	204	0.1
- more than six months but not more than one year	353	0.1	333	0.1
- more than one year	864	0.2	539	0.2
	<u>1,458</u>	<u>0.4</u>	<u>1,076</u>	<u>0.4</u>
of which:				
- individually impaired allowances	(984)		(879)	
- covered portion of overdue loans and advances	553		231	
- uncovered portion of overdue loans and advances	905		845	
- current market value held against the covered portion of overdue loans and advances	1,095		580	

2008

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	340	0.1	183	0.1
- more than six months but not more than one year	419	0.1	380	0.1
- more than one year	311	0.1	95	-
	<u>1,070</u>	<u>0.3</u>	<u>658</u>	<u>0.2</u>
of which:				
- individually impaired allowances	(554)		(501)	
- covered portion of overdue loans and advances	574		373	
- uncovered portion of overdue loans and advances	496		285	
- current market value held against the covered portion of overdue loans and advances	697		549	

Advances with a specific repayment date are classified as overdue when the principal or interest is overdue and remains unpaid at year-end. Advances repayable by regular instalments are treated as overdue when an instalment payment is overdue and remains unpaid at year-end. Advances repayable on demand are classified as overdue either when a demand for repayment has been served on the borrower but repayment has not been made in accordance with the demand notice, or when the advances have remained continuously outside the approved limit advised to the borrower for more than the overdue period in question.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 35 Advances to customers (continued)

#### (e) Rescheduled advances

Rescheduled advances and their expression as a percentage of gross advances to customers are as follows:

	Group		Bank	
		%		%
2009	<u>703</u>	<u>0.2</u>	<u>423</u>	<u>0.1</u>
2008	<u>281</u>	<u>0.1</u>	<u>169</u>	<u>0.1</u>

Rescheduled advances are those that have been rescheduled or renegotiated for reasons related to the borrower's financial difficulties. This will normally involve the granting of concessionary terms and resetting the overdue account to non-overdue status.

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" (note 35(d)).

#### (f) Segmental analysis of advances to customers by geographical area

Advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when an advance is guaranteed by a party located in an area that is different from that of the counterparty. At 31 December 2009, about 90 per cent (about 90 per cent at 31 December 2008) of the Group's advances to customers, including related impaired advances and overdue advances, were classified under Hong Kong. There was no geographical segment other than Hong Kong to which the Bank's advances to customers is not less than 10 per cent of the total loans and advances.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 35 Advances to customers (continued)

#### (g) Gross advances to customers by industry sector

The analysis of gross advances to customers by industry sector based on categories and definitions used by the HKMA is as follows:

	2009	% of gross advances covered by collateral	Group 2008	% of gross advances covered by collateral
<b>Gross advances to customers for use in Hong Kong</b>				
<b>Industrial, commercial and financial sectors</b>				
- property development	23,618	36.1	25,314	32.7
- property investment	75,264	82.3	66,179	87.4
- financial concerns	2,720	33.9	3,146	60.7
- stockbrokers	480	42.9	526	39.2
- wholesale and retail trade	7,812	49.5	6,183	54.3
- manufacturing	12,080	30.4	12,828	27.0
- transport and transport equipment	6,503	83.3	8,400	78.3
- recreational activities	37	41.4	26	64.6
- information technology	1,247	2.4	1,075	4.6
- other	24,405	43.9	21,553	41.7
	<u>154,166</u>	61.8	<u>145,230</u>	62.4
<b>Individuals</b>				
- advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	14,647	99.9	16,739	99.9
- advances for the purchase of other residential properties	96,651	99.7	89,669	99.4
- credit card advances	13,818	-	12,841	-
- other	11,961	45.3	11,892	33.0
	<u>137,077</u>	84.9	<u>131,141</u>	83.7
<b>Total gross advances for use in Hong Kong</b>	<b>291,243</b>	<b>72.7</b>	<b>276,371</b>	<b>72.5</b>
<b>Trade finance</b>	<b>19,215</b>	<b>35.6</b>	<b>19,039</b>	<b>41.5</b>
<b>Gross advances for use outside Hong Kong</b>	<b>36,128</b>	<b>55.4</b>	<b>35,754</b>	<b>59.4</b>
<b>Gross advances to customers</b>	<b><u>346,586</u></b>	<b>68.8</b>	<b><u>331,164</u></b>	<b>69.3</b>

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**35 Advances to customers** (continued)

**(g) Gross advances to customers by industry sector** (continued)

			<b>Bank</b>	
	2009	% of gross advances covered by collateral	2008	% of gross advances covered by collateral
<b>Gross advances to customers for use in Hong Kong</b>				
<b>Industrial, commercial and financial sectors</b>				
- property development	23,618	36.1	25,004	31.9
- property investment	74,128	82.8	64,869	88.0
- financial concerns	2,720	33.9	3,146	60.7
- stockbrokers	480	42.9	526	39.2
- wholesale and retail trade	7,812	49.5	6,181	54.3
- manufacturing	12,079	30.4	12,826	27.0
- transport and transport equipment	4,841	77.6	5,620	67.5
- recreational activities	37	41.4	26	64.6
- information technology	1,247	2.4	1,075	4.6
- other	24,335	44.1	21,524	41.6
	<u>151,297</u>	61.5	<u>140,797</u>	61.6
<b>Individuals</b>				
- advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	3,446	99.6	3,318	99.5
- advances for the purchase of other residential properties	93,028	99.7	84,971	99.4
- credit card advances	13,818	-	12,841	-
- other	11,954	45.3	11,880	32.9
	<u>122,246</u>	83.1	<u>113,010</u>	81.1
<b>Total gross advances for use in Hong Kong</b>	<b>273,543</b>	<b>71.2</b>	<b>253,807</b>	<b>70.3</b>
<b>Trade finance</b>	<b>19,215</b>	<b>35.6</b>	<b>19,039</b>	<b>41.5</b>
<b>Gross advances for use outside Hong Kong</b>	<b>8,084</b>	<b>17.2</b>	<b>9,150</b>	<b>26.9</b>
<b>Gross advances to customers</b>	<b><u>300,842</u></b>	<b>67.4</b>	<b><u>281,996</u></b>	<b>67.0</b>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 35 Advances to customers (continued)

#### (h) Net investments in finance leases

Advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring by the lessee the leased asset at nominal value at the end of the lease period. The total minimum lease payments receivable and their present value at the year-end are as follows:

	Group		Bank	
	2009	2008	2009	2008
Finance leases	24	51	24	51
Hire purchase contracts	5,630	7,329	3,963	4,515
	<u>5,654</u>	<u>7,380</u>	<u>3,987</u>	<u>4,566</u>

	Group		
	Present value of minimum lease payments receivable	Interest income relating to future periods	Total minimum lease payments receivable
<b>2009</b>			
Amounts receivable:			
- within one year	371	93	464
- after one year but within five years	1,486	312	1,798
- after five years	3,813	614	4,427
	<u>5,670</u>	<u>1,019</u>	<u>6,689</u>
Loans impairment allowances	(16)		
Net investments in finance leases and hire purchase contracts	<u>5,654</u>		
<b>2008</b>			
Amounts receivable:			
- within one year	598	148	746
- after one year but within five years	1,981	485	2,466
- after five years	4,825	865	5,690
	<u>7,404</u>	<u>1,498</u>	<u>8,902</u>
Loans impairment allowances	(24)		
Net investments in finance leases and hire purchase contracts	<u>7,380</u>		



## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 35 Advances to customers *(continued)*

#### (h) Net investments in finance leases *(continued)*

	Present value of minimum lease payments receivable	Bank Interest income relating to future periods	Total minimum lease payments receivable
<b>2009</b>			
Amounts receivable:			
- within one year	250	57	307
- after one year but within five years	1,053	196	1,249
- after five years	<u>2,696</u>	<u>462</u>	<u>3,158</u>
	3,999	<u>715</u>	<u>4,714</u>
Loans impairment allowances	<u>(12)</u>		
Net investments in finance leases and hire purchase contracts	<u><u>3,987</u></u>		
<b>2008</b>			
Amounts receivable:			
- within one year	395	88	483
- after one year but within five years	1,315	288	1,603
- after five years	<u>2,875</u>	<u>580</u>	<u>3,455</u>
	4,585	<u>956</u>	<u>5,541</u>
Loans impairment allowances	<u>(19)</u>		
Net investments in finance leases and hire purchase contracts	<u><u>4,566</u></u>		

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 36 Financial investments

	Group		Bank	
	2009	2008	2009	2008
Financial investments:				
- which may be repledged or resold by counterparties	141	1,260	141	219
- which may not be repledged or resold or are not subject to repledge or resale by counterparties	<u>241,361</u>	<u>179,899</u>	<u>156,574</u>	<u>111,781</u>
	<u>241,502</u>	<u>181,159</u>	<u>156,715</u>	<u>112,000</u>
Held-to-maturity debt securities at amortised cost	48,669	36,205	-	-
Available-for-sale at fair value:				
- debt securities	192,486	144,520	156,568	111,726
- equity shares	347	434	147	274
	<u>241,502</u>	<u>181,159</u>	<u>156,715</u>	<u>112,000</u>
Treasury bills	53,973	9,927	49,277	4,304
Certificates of deposit	7,665	12,871	3,126	7,963
Other debt securities	<u>179,517</u>	<u>157,927</u>	<u>104,165</u>	<u>99,459</u>
Debt securities	241,155	180,725	156,568	111,726
Equity shares	347	434	147	274
	<u>241,502</u>	<u>181,159</u>	<u>156,715</u>	<u>112,000</u>

There was no overdue debt securities in 2009 (2008: HK\$5 million).

#### (a) Held-to-maturity debt securities

	Group		Bank	
	2009	2008	2009	2008
Listed in Hong Kong	634	1,227	-	-
Listed outside Hong Kong	<u>5,627</u>	<u>3,301</u>	-	-
	6,261	4,528	-	-
Unlisted	<u>42,408</u>	<u>31,677</u>	-	-
	<u>48,669</u>	<u>36,205</u>	-	-
Issued by public bodies:				
- central governments and central banks	244	240	-	-
- other public sector entities	<u>7,235</u>	<u>2,343</u>	-	-
	7,479	2,583	-	-
Issued by other bodies:				
- banks and other financial institutions	32,145	29,604	-	-
- corporate entities	<u>9,045</u>	<u>4,018</u>	-	-
	41,190	33,622	-	-
	<u>48,669</u>	<u>36,205</u>	-	-
Fair value of held-to-maturity debt securities:				
- listed	6,384	4,849	-	-
- unlisted	<u>43,421</u>	<u>34,466</u>	-	-
	<u>49,805</u>	<u>39,315</u>	-	-

There were no held-to-maturity debt securities determined to be impaired at 31 December 2009 for the Group and the Bank (2008: Nil).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 36 Financial investments (continued)

#### (b) Available-for-sale debt securities

	Group		Bank	
	2009	2008	2009	2008
Listed in Hong Kong	6,973	4,377	6,960	4,369
Listed outside Hong Kong	60,991	63,717	45,769	50,273
	<u>67,964</u>	<u>68,094</u>	<u>52,729</u>	<u>54,642</u>
Unlisted	124,522	76,426	103,839	57,084
	<u>192,486</u>	<u>144,520</u>	<u>156,568</u>	<u>111,726</u>
Issued by public bodies:				
- central governments and central banks	64,532	16,403	58,372	10,238
- other public sector entities	17,830	2,010	14,974	2,010
	<u>82,362</u>	<u>18,413</u>	<u>73,346</u>	<u>12,248</u>
Issued by other bodies:				
- banks and other financial institutions	101,167	114,563	77,782	91,096
- corporate entities	8,957	11,544	5,440	8,382
	<u>110,124</u>	<u>126,107</u>	<u>83,222</u>	<u>99,478</u>
	<u>192,486</u>	<u>144,520</u>	<u>156,568</u>	<u>111,726</u>

As at 31 December 2009, there was no available-for-sale debt securities individually determined to be impaired for the Group and the Bank. As at 31 December 2008, the Group's and the Bank's available-for-sale debt securities were individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities. Impairment losses on these investments were recognised in the income statement in accordance with the accounting policy set out in Note 4(v)(ii).

#### (c) Available-for-sale equity shares

	Group		Bank	
	2009	2008	2009	2008
Listed in Hong Kong	60	37	5	3
Listed outside Hong Kong	85	68	85	68
	<u>145</u>	<u>105</u>	<u>90</u>	<u>71</u>
Unlisted	202	329	57	203
	<u>347</u>	<u>434</u>	<u>147</u>	<u>274</u>
Issued by corporate entities	<u>347</u>	<u>434</u>	<u>147</u>	<u>274</u>

During the year of 2009 and 2008, certain Group's and the Bank's available-for-sale equity securities were individually determined to be impaired. Impairment losses on these investments were recognised in the income statement in accordance with the accounting policy set out in note 4(v)(ii).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 37 Investments in subsidiaries

	<b>Bank</b>	
	<b>2009</b>	2008
Unlisted shares, at cost	<u><b>11,584</b></u>	<u>11,284</u>

The principal subsidiaries of the Bank are:

<u>Name of company</u>	<u>Place of incorporation</u>	<u>Principal activities</u>	<u>Issued equity capital</u>
Hang Seng Bank (China) Limited	People's Republic of China	Banking	RMB4,500,000,000
Hang Seng Finance Limited	Hong Kong SAR	Lending	HK\$1,000,000,000
Hang Seng Credit Limited	Hong Kong SAR	Lending	HK\$200,000,000
Hang Seng Bank (Bahamas) Limited	Bahamas	Banking	US\$1,000,000
Hang Seng Finance (Bahamas) Limited	Bahamas	Finance	US\$5,000
Hang Seng Bank (Trustee) Limited	Hong Kong SAR	Trustee service	HK\$3,000,000
Hang Seng (Nominee) Limited	Hong Kong SAR	Nominee service	HK\$100,000
Hang Seng Life Limited	Hong Kong SAR	Retirement benefits and life assurance	HK\$970,000,000
Hang Seng Insurance Company Limited	Hong Kong SAR	Retirement benefits and life assurance	HK\$4,626,184,570
Hang Seng General Insurance (Hong Kong) Company Limited	Hong Kong SAR	General insurance	HK\$620,000,000
Hang Seng Asset Management Pte Ltd	Singapore	Fund management	SG\$2,000,000
Hang Seng Investment Management Limited	Hong Kong SAR	Fund management	HK\$10,000,000
Haseba Investment Company Limited	Hong Kong SAR	Investment holding	HK\$6,000
Hang Seng Securities Limited	Hong Kong SAR	Stockbroking	HK\$26,000,000
Yan Nin Development Company Limited	Hong Kong SAR	Investment holding	HK\$100,000
Hang Seng Indexes Company Limited	Hong Kong SAR	Compilation and dissemination of the Hang Seng share index	HK\$10,000
Hang Seng Real Estate Management Limited	Hong Kong SAR	Property management	HK\$10,000

All the above companies are wholly-owned subsidiaries and unlisted. All subsidiaries are held directly by the Bank except for Hang Seng Life Limited and Hang Seng Indexes Company Limited. The principal places of operation are the same as the places of incorporation.

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

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 38 Investments in associates

	Group		Bank	
	2009	2008	2009	2008
Unlisted investments, at cost	-	-	912	909
Listed investments, at cost	-	-	1,634	1,634
Share of net assets	9,691	8,314	-	-
Intangible asset	106	157	-	-
Goodwill	429	399	-	-
	<u>10,226</u>	<u>8,870</u>	<u>2,546</u>	<u>2,543</u>

The associates are:

<u>Name of company</u>	<u>Place of incorporation and operation</u>	<u>Principal activity</u>	<u>Group's interest in equity capital</u>	<u>Issued equity capital</u>
<b>Unlisted</b>				
Barrowgate Limited	Hong Kong SAR	Property investment	24.64%	HK\$10,000
Yantai Bank Co., Ltd. (Formerly known as Yantai City Commercial Bank)	People's Republic of China	Banking	20.00%	RMB2,000,000,000
<b>Listed</b>				
Industrial Bank Co., Ltd.	People's Republic of China	Banking	12.78%	RMB5,000,000,000

Investment in associates included listed investment of HK\$8,406 million (2008: HK\$7,078 million). At the end of the reporting period, the fair value of these investments, based on quoted market prices was HK\$29,261 million (2008: HK\$10,599 million).

In accordance with HKAS 28, an associate is an entity over which the investor has significant influence, including the power to participate in the financial and operating policy decisions without controlling the management of the investee. Usually a holding of less than 20 per cent is presumed not to have significant influence, unless such influence can be clearly demonstrated. The investments are recognised at cost and dividends accounted for as declared.

The interest in Barrowgate Limited is owned by a subsidiary of the Bank. The interest in Industrial Bank Co., Ltd. and Yantai Bank Co., Ltd. ("Yantai Bank") are owned directly by the Bank.

The Group's investment in Industrial Bank Co., Ltd. ("IB") has been accounted for as an associate using the equity method as the Group has representation in both the Board and Executive Committee of IB, and the ability to participate in the decision making process.

For the year ended 31 December 2009, the financial results of Industrial Bank Co., Ltd. and Yantai Bank were included in the financial statements based on financial statements drawn up to 30 September 2009, but taking into account any changes in the subsequent period from 1 October 2009 to 31 December 2009 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.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 38 Investments in associates (continued)

In February 2007, IB issued 1,001 million new shares in an Initial Public Offer for a total consideration of RMB15,996 million. The Bank did not subscribe for any additional shares and, thus, its interest in the equity of IB decreased from 15.98 per cent to 12.78 per cent. The decrease of the Bank's interest in the equity of Industrial Bank Co., Ltd. does not affect the Bank's influence over this associate, as there has been no change in the composition of major shareholders in IB or in the Bank's representation on its Board of Directors or Executive Committee. The Bank will continue to have the power to participate in the financial and operating policy decisions of IB, and will continue to account for its results using the equity method.

The following table shows the summarised financial information of the associates with the aggregated amounts in which the Group's interests have been accounted for:

	<b>Assets</b>	<b>Liabilities</b>	<b>Equity</b>	<b>Revenue</b>	<b>Expenses</b>	<b>Profit</b>
<b>2009</b>						
100 per cent	<b>1,473,189</b>	<b>1,402,699</b>	<b>70,490</b>	<b>34,418</b>	<b>21,038</b>	<b>13,380</b>
Group's effective interest	<b>191,044</b>	<b>181,353</b>	<b>9,691</b>	<b>4,496</b>	<b>2,748</b>	<b>1,748</b>
2008						
100 per cent	1,087,222	1,027,344	59,878	32,594	18,783	13,811
Group's effective interest	141,824	133,510	8,314	4,216	2,409	1,807

There is no impairment loss of our investments in associates for the years ended 31 December 2009 and 2008.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 39 Investment properties

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2009, and were updated for any material changes in the valuation as at 31 December 2009. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation for investment properties was open market value.

#### (a) Movement of investment properties

	Group		Bank	
	2009	2008	2009	2008
At 1 January	2,593	2,581	1,714	1,708
Surplus on revaluation credited to income statement (note 22)	250	8	153	1
Transfer from assets held for sale	16	-	16	-
Transfer from premises (note 40(a))	13	4	-	5
At 31 December	<u>2,872</u>	<u>2,593</u>	<u>1,883</u>	<u>1,714</u>

#### (b) Terms of lease

	Group		Bank	
	2009	2008	2009	2008
<b>Leaseholds</b>				
Held in Hong Kong:				
- long leases (over 50 years unexpired)	1,272	1,137	506	467
- medium leases (10 to 50 years unexpired)	1,600	1,456	1,377	1,247
Held outside Hong Kong:				
- medium leases (10 to 50 years unexpired)	-	-	-	-
	<u>2,872</u>	<u>2,593</u>	<u>1,883</u>	<u>1,714</u>

- (c) The Group leases out investment properties under operating leases. The leases typically run for an initial period of 2 years, and may contain an option to renew the lease after that date at which time all terms are renegotiated. None of the leases includes contingent rentals.

The direct operating expenses arising from investment properties were HK\$21 million in 2009 (2008: HK\$18 million). Of this amount, HK\$20 million (2008: HK\$17 million) was the direct operating expenses from investment properties that generated rental income.

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

	Group		Bank	
	2009	2008	2009	2008
Less than one year	107	117	67	77
Over one year but within five years	54	72	35	57
	<u>161</u>	<u>189</u>	<u>102</u>	<u>134</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 40 Premises, plant and equipment

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2009, and were updated for any material changes in the valuation as at 31 December 2009. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use.

#### (a) Movement of premises, plant and equipment

2009	Group		
	Premises	Plant and equipment	Total
Cost or valuation:			
At 1 January	6,161	3,421	9,582
Additions	-	160	160
Disposals	-	(192)	(192)
Elimination of accumulated depreciation on revalued premises	(162)	-	(162)
Surplus on revaluation:			
- credited to premises revaluation reserve	700	-	700
- debited to income statement (note 22)	(31)	-	(31)
Transfer to assets held for sale	(253)	-	(253)
Transfer to investment property (note 39(a))	(13)	-	(13)
Other	-	(2)	(2)
At 31 December	<u>6,402</u>	<u>3,387</u>	<u>9,789</u>
Accumulated depreciation:			
At 1 January	-	(2,492)	(2,492)
Charge for the year (note 17)	(162)	(304)	(466)
Written off on disposal	-	185	185
Elimination of accumulated depreciation on revalued premises	162	-	162
At 31 December	<u>-</u>	<u>(2,611)</u>	<u>(2,611)</u>
Net book value at 31 December	<u>6,402</u>	<u>776</u>	<u>7,178</u>



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 40 Premises, plant and equipment (continued)

#### (a) Movement of premises, plant and equipment (continued)

2008	Group		
	Premises	Plant and equipment	Total
Cost or valuation:			
At 1 January	6,082	3,186	9,268
Exchange adjustments	6	16	22
Additions	-	491	491
Disposals	-	(272)	(272)
Elimination of accumulated depreciation on revalued premises	(165)	-	(165)
Surplus on revaluation:			
- credited to premises revaluation reserve	171	-	171
- credited to income statement (note 22)	71	-	71
Transfer to investment property (note 39(a))	(4)	-	(4)
At 31 December	<u>6,161</u>	<u>3,421</u>	<u>9,582</u>
Accumulated depreciation:			
At 1 January	-	(2,474)	(2,474)
Exchange adjustments	-	(6)	(6)
Charge for the year (note 17)	(165)	(267)	(432)
Written off on disposal	-	254	254
Elimination of accumulated depreciation on revalued premises	165	-	165
Other	-	1	1
At 31 December	<u>-</u>	<u>(2,492)</u>	<u>(2,492)</u>
Net book value at 31 December	<u>6,161</u>	<u>929</u>	<u>7,090</u>
		<b>Bank</b>	
<b>2009</b>	<b>Premises</b>	<b>Plant and equipment</b>	<b>Total</b>
Cost or valuation:			
At 1 January	3,591	3,050	6,641
Additions	-	142	142
Disposals	-	(186)	(186)
Elimination of accumulated depreciation on revalued premises	(100)	-	(100)
Surplus on revaluation:			
- credited to premises revaluation reserve	395	-	395
- debited to income statement	(31)	-	(31)
Transfer to assets held for sale	(254)	-	(254)
At 31 December	<u>3,601</u>	<u>3,006</u>	<u>6,607</u>
Accumulated depreciation:			
At 1 January	-	(2,347)	(2,347)
Charge for the year	(100)	(243)	(343)
Written off on disposal	-	181	181
Elimination of accumulated depreciation on revalued premises	100	-	100
At 31 December	<u>-</u>	<u>(2,409)</u>	<u>(2,409)</u>
Net book value at 31 December	<u>3,601</u>	<u>597</u>	<u>4,198</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 40 Premises, plant and equipment (continued)

#### (a) Movement of premises, plant and equipment (continued)

2008	Premises	Bank	Total
		Plant and equipment	
Cost or valuation:			
At 1 January	3,578	2,927	6,505
Additions	-	378	378
Disposals	-	(255)	(255)
Elimination of accumulated depreciation on revalued premises	(102)	-	(102)
Surplus on revaluation:			
- credited to premises revaluation reserve	49	-	49
- credited to income statement	71	-	71
Transfer to investment property (note 39(a))	(5)	-	(5)
At 31 December	<u>3,591</u>	<u>3,050</u>	<u>6,641</u>
Accumulated depreciation:			
At 1 January	-	(2,378)	(2,378)
Charge for the year	(102)	(210)	(312)
Written off on disposal	-	241	241
Elimination of accumulated depreciation on revalued premises	102	-	102
At 31 December	<u>-</u>	<u>(2,347)</u>	<u>(2,347)</u>
Net book value at 31 December	<u>3,591</u>	<u>703</u>	<u>4,294</u>

#### (b) Terms of lease

The net book value of premises comprises:

	Group		Bank	
	2009	2008	2009	2008
<b>Leaseholds</b>				
Held in Hong Kong:				
- long leases (over 50 years unexpired)	1,583	1,448	796	717
- medium leases (10 to 50 years unexpired)	4,670	4,601	2,773	2,874
- short leases (under 10 years unexpired)	31	-	31	-
Held outside Hong Kong:				
- long leases (over 50 years unexpired)	7	6	-	-
- medium leases (10 to 50 years unexpired)	111	106	1	-
	<u>6,402</u>	<u>6,161</u>	<u>3,601</u>	<u>3,591</u>

(c) The carrying amount of all premises which have been stated in the statement of financial position would have been as follows had they been stated at cost less accumulated depreciation:

	Group		Bank	
	2009	2008	2009	2008
Cost less accumulated depreciation at 31 December	<u>1,822</u>	<u>1,879</u>	<u>701</u>	<u>725</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 41 Interest in leasehold land held for own use under operating lease

The Group's interest in leasehold land held for own use is accounted for as operating lease. The lease is a medium term lease with 10 to 50 years unexpired and the net book value is as follows:

	Group		Bank	
	2009	2008	2009	2008
At 1 January	551	565	551	565
Amortisation of prepaid operating lease payment (note 17)	(15)	(14)	(15)	(14)
At 31 December	<u>536</u>	<u>551</u>	<u>536</u>	<u>551</u>

### 42 Intangible assets

	Group		Bank	
	2009	2008	2009	2008
Present value of in-force long-term insurance business	3,466	2,707	-	-
Internally developed software	385	321	384	321
Acquired software	34	28	15	21
Goodwill	329	329	-	-
	<u>4,214</u>	<u>3,385</u>	<u>399</u>	<u>342</u>

#### (a) Movement of present value of in-force long-term insurance business

	Group	
	2009	2008
At 1 January	2,707	2,324
Addition from current year new business	747	838
Movement from in-force business	12	(455)
At 31 December	<u>3,466</u>	<u>2,707</u>

The key assumptions used in the computation of present value of in-force long-term insurance business ("PVIF") are as follows:

	2009	2008
Risk discount rate	11.0%	11.0%
Expenses inflation	3.0%	3.0%
Average lapse rate:		
- 1st year	3.4%	2.9%
- 2nd year onwards	1.4%	1.6%

The sensitivity of PVIF valuation to changes in individual assumptions at the end of the reporting periods is shown in note 62(d).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 42 Intangible assets (continued)

#### (b) Goodwill

	Group		Bank	
	2009	2008	2009	2008
At 1 January and at 31 December	<u>329</u>	<u>329</u>	<u>-</u>	<u>-</u>

Goodwill arising from acquisition of the remaining 50 per cent of Hang Seng Life Limited from HSBC Insurance (Asia-Pacific) Holdings Limited amounted to HK\$329 million is allocated to cash-generating units of Personal Financial Services (Life Insurance) - Hang Seng Insurance Company Limited ("HSIC") for the purpose of impairment testing.

During 2009, there was no impairment of goodwill (2008: Nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating unit based on appraisal value with the carrying amount of its net assets, including attributable goodwill.

The appraisal value comprises HSIC's net assets (other than value of business acquired and goodwill) as at 31 December 2009, the present value of in-force long-term insurance business and the expected value of future business. The present value of the in-force long-term insurance business is determined by discounting future earnings expected from the current business, taking into account factors such as future mortality, lapse rates, levels of expenses and risk discount rate. The above details are shown in notes 42(a) and 62(d).

#### (c) Movement of internally developed application software and acquired software

	Group		Bank	
	2009	2008	2009	2008
Cost:				
At 1 January	532	366	522	364
Additions	152	175	138	166
Disposals	(20)	(9)	(19)	(8)
Other	2	-	-	-
At 31 December	<u>666</u>	<u>532</u>	<u>641</u>	<u>522</u>
Accumulated amortisation:				
At 1 January	(183)	(130)	(180)	(130)
Charge for the year (note 17)	(84)	(60)	(81)	(58)
Written off on disposals	20	8	19	8
Other	-	(1)	-	-
At 31 December	<u>(247)</u>	<u>(183)</u>	<u>(242)</u>	<u>(180)</u>
Net book value at 31 December	<u>419</u>	<u>349</u>	<u>399</u>	<u>342</u>

During 2009, there was no impairment on internally developed application software and acquired software (2008: Nil).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 43 Other assets

	Group		Bank	
	2009	2008	2009	2008
Items in the course of collection from other banks	4,343	4,028	4,343	4,017
Prepayments and accrued income	1,835	2,711	804	1,616
Assets held for sale*				
- repossessed assets	47	136	30	104
- other assets held for sale	-	16	-	16
Acceptances and endorsements	3,584	3,090	2,435	2,255
Retirement benefit assets	86	30	86	30
Other accounts	1,174	1,495	538	834
	<u>11,069</u>	<u>11,506</u>	<u>8,236</u>	<u>8,872</u>

\* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2009 and 2008.

There are no significant impaired, overdue or rescheduled other assets at the year-end.

### 44 Current, savings and other deposit accounts

	Group		Bank	
	2009	2008	2009	2008
Current, savings and other deposit accounts:				
- as stated in statement of financial position	636,369	562,183	612,014	547,385
- structured deposits reported as trading liabilities (note 45)	22,212	29,785	18,892	24,970
	<u>658,581</u>	<u>591,968</u>	<u>630,906</u>	<u>572,355</u>
By type:				
- demand and current accounts	53,450	36,321	53,409	37,616
- savings accounts	437,440	294,556	429,062	289,296
- time and other deposits	167,691	261,091	148,435	245,443
	<u>658,581</u>	<u>591,968</u>	<u>630,906</u>	<u>572,355</u>

### 45 Trading liabilities

	Group		Bank	
	2009	2008	2009	2008
Structured certificates of deposit in issue (note 47)	478	3,861	478	3,861
Other debt securities in issue (note 47)	2,769	5,855	2,769	5,855
Structured deposits (note 44)	22,212	29,785	18,892	24,970
Short positions in securities and other	12,932	8,781	12,932	8,781
	<u>38,391</u>	<u>48,282</u>	<u>35,071</u>	<u>43,467</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 46 Financial liabilities designated at fair value

	Group		Bank	
	2009	2008	2009	2008
4.125% callable fixed rate subordinated notes (note 51)	1,003	994	1,003	994
Liabilities to customers under investment contracts	453	413	-	-
	<u>1,456</u>	<u>1,407</u>	<u>1,003</u>	<u>994</u>

At 31 December 2009, the difference between the carrying amount and the contractual amount of subordinated notes payable at maturity for the Group and the Bank amounted to HK\$3 million (2008: HK\$6 million). The accumulated amount of the change in fair value attributable to change in credit risk for the Group and the Bank was HK\$46 million (2008: HK\$54 million) and the change for the year ended 31 December 2009 was HK\$8 million (2008: HK\$42 million) for the Group and the Bank.

### 47 Certificates of deposit and other debt securities in issue

	Group		Bank	
	2009	2008	2009	2008
Certificates of deposit and other debt securities in issue:				
- as stated in statement of financial position	1,826	2,772	1,826	2,772
- structured certificates of deposit in issue reported as trading liabilities (note 45)	478	3,861	478	3,861
- other structured debt securities in issue reported as trading liabilities (note 45)	2,769	5,855	2,769	5,855
	<u>5,073</u>	<u>12,488</u>	<u>5,073</u>	<u>12,488</u>
By type:				
- certificates of deposit in issue	2,304	6,633	2,304	6,633
- other debt securities in issue	2,769	5,855	2,769	5,855
	<u>5,073</u>	<u>12,488</u>	<u>5,073</u>	<u>12,488</u>

### 48 Other liabilities

	Group		Bank	
	2009	2008	2009	2008
Items in the course of transmission to other banks	6,304	4,583	6,303	4,575
Accruals	2,039	2,924	1,668	2,471
Acceptances and endorsements	3,584	3,090	2,435	2,255
Retirement benefit liabilities	1,712	3,532	1,712	3,532
Other	1,646	1,319	2,215	1,977
	<u>15,285</u>	<u>15,448</u>	<u>14,333</u>	<u>14,810</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 49 Liabilities to customers under insurance contracts

	Group					
	2009			2008		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
<b>Non-life insurance</b>						
Unearned premiums	192	(52)	140	199	(42)	157
Notified claims	146	(19)	127	162	(22)	140
Claims incurred but not reported	43	(8)	35	43	(8)	35
Other	47	(1)	46	26	(3)	23
	<b>428</b>	<b>(80)</b>	<b>348</b>	430	(75)	355
<b>Policyholders' liabilities</b>						
Life (non-linked)	53,588	(19)	53,569	43,211	(18)	43,193
Life (linked)	224	-	224	194	-	194
	<b>53,812</b>	<b>(19)</b>	<b>53,793</b>	43,405	(18)	43,387
	<b>54,240</b>	<b>(99)</b>	<b>54,141</b>	43,835	(93)	43,742

Amounts recoverable from reinsurance of liabilities under insurance contracts issued are included in the consolidated statement of financial position in "Other assets".

The movement of liabilities under insurance contracts was as follows:

#### (a) Non-life insurance

	Group		
	Gross	Reinsurance	Net
<b>2009</b>			
<b>Unearned premiums</b>			
At 1 January	199	(42)	157
Gross written premiums	422	(93)	329
Gross earned premiums	(404)	78	(326)
Exchange and other movements	(25)	5	(20)
At 31 December	<b>192</b>	<b>(52)</b>	<b>140</b>
<b>Notified and incurred but not reported claims</b>			
At 1 January			
- notified claims	162	(22)	140
- claims incurred but not reported	43	(8)	35
	<b>205</b>	<b>(30)</b>	<b>175</b>
Claims paid	(119)	10	(109)
Claims incurred	103	(11)	92
	<b>(16)</b>	<b>(1)</b>	<b>(17)</b>
Exchange and other movements	-	4	4
At 31 December			
- notified claims	146	(19)	127
- claims incurred but not reported	43	(8)	35
	<b>189</b>	<b>(27)</b>	<b>162</b>
<b>Other</b>	<b>47</b>	<b>(1)</b>	<b>46</b>
	<b>428</b>	<b>(80)</b>	<b>348</b>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 49 Liabilities to customers under insurance contracts (continued)

#### (a) Non-life insurance (continued)

	Group		
	Gross	Reinsurance	Net
2008			
<b>Unearned premiums</b>			
At 1 January	191	(37)	154
Gross written premiums	411	(80)	331
Gross earned premiums	(403)	75	(328)
At 31 December	<u>199</u>	<u>(42)</u>	<u>157</u>
<b>Notified and incurred but not reported claims</b>			
At 1 January			
- notified claims	147	(12)	135
- claims incurred but not reported	42	(10)	32
	189	(22)	167
Claims paid	(130)	33	(97)
Claims incurred	146	(41)	105
	16	(8)	8
At 31 December			
- notified claims	162	(22)	140
- claims incurred but not reported	43	(8)	35
	<u>205</u>	<u>(30)</u>	<u>175</u>
<b>Other</b>			
	26	(3)	23
	<u>430</u>	<u>(75)</u>	<u>355</u>

#### (b) Policyholders' liabilities

	Group		
	Gross	Reinsurance	Net
2009			
<b>Life (non-linked)</b>			
At 1 January	43,211	(18)	43,193
Benefits paid	(1,811)	18	(1,793)
Claims incurred and movement in policyholders' liabilities	11,877	(19)	11,858
Exchange and other movements	311	-	311
At 31 December	<u>53,588</u>	<u>(19)</u>	<u>53,569</u>
<b>Life (linked)</b>			
At 1 January	194	-	194
Benefits paid	(19)	-	(19)
Claims incurred and movement in policyholders' liabilities	54	-	54
Exchange and other movements	(5)	-	(5)
At 31 December	<u>224</u>	<u>-</u>	<u>224</u>
	<u>53,812</u>	<u>(19)</u>	<u>53,793</u>



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 49 Liabilities to customers under insurance contracts (continued)

#### (b) Policyholders' liabilities (continued)

2008	Group		
	Gross	Reinsurance	Net
<b>Life (non-linked)</b>			
At 1 January	32,444	(10)	32,434
Benefits paid	(646)	14	(632)
Claims incurred and movement in policyholders' liabilities	11,391	(22)	11,369
Exchange and other movements	22	-	22
At 31 December	<u>43,211</u>	<u>(18)</u>	<u>43,193</u>
<b>Life (linked)</b>			
At 1 January	235	-	235
Benefits paid	(30)	-	(30)
Claims incurred and movement in policyholders' liabilities	(11)	-	(11)
At 31 December	<u>194</u>	<u>-</u>	<u>194</u>
	<u>43,405</u>	<u>(18)</u>	<u>43,387</u>

### 50 Current tax and deferred tax

(a) Current tax and deferred tax assets and liabilities are represented in the statement of financial position:

	Group		Bank	
	2009	2008	2009	2008
Current taxation recoverable (included in "Other assets")	5	25	-	-
Deferred tax assets	<u>16</u>	<u>201</u>	<u>2</u>	<u>187</u>
	<u>21</u>	<u>226</u>	<u>2</u>	<u>187</u>
Current tax liabilities:				
Provision for Hong Kong profits tax	41	91	2	65
Provision for taxation outside Hong Kong	<u>11</u>	<u>3</u>	<u>8</u>	<u>1</u>
	<u>52</u>	<u>94</u>	<u>10</u>	<u>66</u>
Deferred tax liabilities	<u>1,684</u>	<u>711</u>	<u>569</u>	<u>-</u>
	<u>1,736</u>	<u>805</u>	<u>579</u>	<u>66</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 50 Current tax and deferred tax (continued)

#### (b) Deferred tax assets and liabilities recognised

The major components of deferred tax (assets)/liabilities recognised in the statement of financial position and the movements during the year are as follows:

	Group						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available -for-sale financial assets	Cash flow hedge	Other	Total
<b>2009</b>							
At 1 January	124	1,098	(99)	(476)	104	(241)	510
(Credited)/charged to income statement (note 23(a))	(5)	18	-	-	-	352	365
Charged/(credited) to reserves	-	72	-	481	(69)	309	793
At 31 December	<u>119</u>	<u>1,188</u>	<u>(99)</u>	<u>5</u>	<u>35</u>	<u>420</u>	<u>1,668</u>
<b>2008</b>							
At 1 January	98	1,149	(97)	(69)	29	254	1,364
Charged/(credited) to income statement (note 23(a))	26	(32)	(2)	-	-	(9)	(17)
(Credited)/charged to reserves	-	(19)	-	(407)	75	(486)	(837)
At 31 December	<u>124</u>	<u>1,098</u>	<u>(99)</u>	<u>(476)</u>	<u>104</u>	<u>(241)</u>	<u>510</u>

	Bank						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available -for-sale financial assets	Cash flow hedge	Other	Total
<b>2009</b>							
At 1 January	126	771	(98)	(480)	104	(610)	(187)
(Credited)/charged to income statement	(8)	8	-	-	-	7	7
Charged/(credited) to reserves	-	23	-	484	(69)	309	747
At 31 December	<u>118</u>	<u>802</u>	<u>(98)</u>	<u>4</u>	<u>35</u>	<u>(294)</u>	<u>567</u>
<b>2008</b>							
At 1 January	105	820	(96)	(100)	29	(109)	649
Charged/(credited) to income statement	21	(22)	(2)	-	-	(16)	(19)
(Credited)/charged to reserves	-	(27)	-	(380)	75	(485)	(817)
At 31 December	<u>126</u>	<u>771</u>	<u>(98)</u>	<u>(480)</u>	<u>104</u>	<u>(610)</u>	<u>(187)</u>

#### (c) Deferred tax assets not recognised

At the end of the reporting period, the Group has not recognised deferred tax assets in respect of tax losses of subsidiaries amounting to HK\$25 million (2008: HK\$29 million) which are considered unlikely to be utilised. There is no expiry provisions for tax losses.

#### (d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised in 2009 (2008: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

51 Subordinated liabilities

	Description	Group		Bank	
		2009	2008	2009	2008
Nominal value					
<b>Amount owed to third parties</b>					
HK\$1,500 million	Callable floating rate subordinated notes due June 2015 <sup>(1)</sup>	1,499	1,498	1,499	1,498
HK\$1,000 million	4.125% callable fixed rate subordinated notes due June 2015 <sup>(2)</sup>	1,003	994	1,003	994
US\$450 million	Callable floating rate subordinated notes due July 2016 <sup>(3)</sup>	3,483	3,478	3,483	3,478
US\$300 million	Callable floating rate subordinated notes due July 2017 <sup>(4)</sup>	2,321	2,318	2,321	2,318
<b>Amount owed to HSBC Group undertakings</b>					
US\$260 million	Callable floating rate subordinated loan debt due December 2015 <sup>(5)</sup>	2,017	2,015	2,017	2,015
		<u>10,323</u>	<u>10,303</u>	<u>10,323</u>	<u>10,303</u>
Representing:					
- measured at amortised cost		9,320	9,309	9,320	9,309
- designated at fair value (note 46)		1,003	994	1,003	994
		<u>10,323</u>	<u>10,303</u>	<u>10,323</u>	<u>10,303</u>

The above subordinated notes and loan each carries a one-time call option exercisable by the Group on a day falling five years plus one day after the relevant date of issue/drawdown.

- (1) Interest rate at three-month HIBOR plus 0.35 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month HIBOR plus 0.85 per cent, payable quarterly.
- (2) Interest rate at 4.125 per cent per annum, payable semi-annually, to the call option date. Thereafter, it will be reset to three-month HIBOR plus 0.825 per cent, payable quarterly.
- (3) Interest rate at three-month US dollar LIBOR plus 0.30 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month US dollar LIBOR plus 0.80 per cent, payable quarterly.
- (4) Interest rate at three-month US dollar LIBOR plus 0.25 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month US dollar LIBOR plus 0.75 per cent, payable quarterly.
- (5) Interest rate at three-month US dollar LIBOR plus 0.31 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month US dollar LIBOR plus 0.81 per cent, payable quarterly.

52 Share capital

Authorised:

The authorised share capital of the Bank is HK\$11,000 million (2008: HK\$11,000 million) divided into 2,200 million shares (2008: 2,200 million shares) of HK\$5 each.

	2009	2008
Issued and fully paid:		
1,911,842,736 shares (2008: 1,911,842,736 shares) of HK\$5 each	<u>9,559</u>	<u>9,559</u>

During the year, the Bank made no repurchase of its own shares (2008: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

53 Reserves

The reconciliation between the opening and closing balances of each component of the Group's consolidated equity is set out in the consolidated statement of changes in equity. Details of the changes in the Bank's individual components of equity between the beginning and the end of the year are set out below:

	<b>Bank</b>	
	<b>2009</b>	2008
Retained profits (including proposed dividends)	<b>21,494</b>	21,299
Premises revaluation reserve	<b>2,556</b>	2,503
Cash flow hedge reserve	<b>180</b>	528
Available-for-sale investment reserve:		
- on debt securities	<b>(51)</b>	(2,532)
- on equity securities	<b>50</b>	177
Capital redemption reserve	<b>99</b>	99
Other reserves	<b>459</b>	420
Total reserves (including proposed dividends)	<u><b>24,787</b></u>	<u>22,494</u>
<i>Retained profits (including proposed dividends)</i>		
At beginning of the year	<b>21,299</b>	24,947
Dividends to shareholders		
- dividends approved in respect of the previous year	<b>(5,736)</b>	(5,736)
- dividends declared in respect of the current year	<b>(6,309)</b>	(6,309)
Transfer	<b>319</b>	95
Total comprehensive income for the year	<u><b>11,921</b></u>	<u>8,302</u>
	<u><b>21,494</b></u>	<u>21,299</u>
<i>Premises revaluation reserve</i>		
At beginning of the year	<b>2,503</b>	2,522
Transfer	<b>(319)</b>	(95)
Total comprehensive income for the year	<u><b>372</b></u>	<u>76</u>
	<u><b>2,556</b></u>	<u>2,503</u>
<i>Available-for-sale investment reserve</i>		
At beginning of the year	<b>(2,355)</b>	(95)
Total comprehensive income for the year	<u><b>2,354</b></u>	<u>(2,260)</u>
	<u><b>(1)</b></u>	<u>(2,355)</u>
<i>Cash flow hedge reserve</i>		
At beginning of the year	<b>528</b>	137
Total comprehensive income for the year	<u><b>(348)</b></u>	<u>391</u>
	<u><b>180</b></u>	<u>528</u>
<i>Capital redemption reserve</i>		
At beginning of the year	<b>99</b>	99
Total comprehensive income for the year	<u><b>-</b></u>	<u>-</u>
	<u><b>99</b></u>	<u>99</u>
<i>Other reserve</i>		
At beginning of the year	<b>420</b>	298
Costs of share-based payment arrangements	<b>35</b>	127
Total comprehensive income for the year	<u><b>4</b></u>	<u>(5)</u>
	<u><b>459</b></u>	<u>420</u>
Total reserves (including proposed dividends)	<u><b>24,787</b></u>	<u>22,494</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 53 Reserves (continued)

The Bank and its banking subsidiaries operate under regulatory jurisdictions which require the maintenance of minimum capital adequacy ratios and which could therefore potentially restrict the amount of retained profits which can be distributed to shareholders.

#### *Regulatory reserve*

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a "regulatory reserve" from retained profits. Movements in the reserve are made directly through retained earnings. As at 31 December 2009, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group to shareholders by HK\$920 million (2008: HK\$854 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.

#### *Premises revaluation reserve*

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

The premises revaluation reserve included nil amount in relation to properties classified as assets held for sale, included in "Other assets" in the consolidated statement of financial position at 31 December 2009 (31 December 2008: Nil).

#### *Cash flow hedge reserve*

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

#### *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.

#### *Capital redemption reserve*

Capital redemption reserve represents the difference between the capital payment and the nominal value of the redeemed share capital.

#### *Other reserves*

Other reserves mainly comprise foreign exchange reserve, share based payment reserve and other non-distributable reserves. The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations. The share based payment reserve is used to record the corresponding amount of share options granted by ultimate holding company to the Group's employees and other cost of share based payment arrangement.

"Premises revaluation reserve", "Cash flow hedge reserve", "Available-for-sale investment reserve", "Capital redemption reserve" and "Other reserves" do not represent realised profits and are not available for distribution.

NOTES TO THE FINANCIAL STATEMENTS (continued)

54 Reconciliation of cash flow statement

(a) Reconciliation of operating profit to net cash flow from operating activities

	2009	2008
Operating profit	13,324	13,725
Net interest income	(14,023)	(16,232)
Dividend income	(16)	(82)
Loan impairment charges and other credit risk provisions	812	2,776
Impairment of available-for-sale equity securities	4	284
Depreciation	466	432
Amortisation of intangible assets	84	60
Amortisation of available-for-sale investments	76	(398)
Amortisation of held-to-maturity debt securities	1	1
Advances written off net of recoveries	(858)	(400)
Interest received	11,126	16,232
Interest paid	(1,478)	(9,249)
<b>Operating profit before changes in working capital</b>	<b>9,518</b>	<b>7,149</b>
Change in treasury bills and certificates of deposit with original maturity more than three months	(41,353)	14,016
Change in placings with and advances to banks maturing after one month	(5,418)	(2,895)
Change in trading assets	77,386	(100,363)
Change in financial assets designated at fair value	(2,549)	(276)
Change in derivative financial instruments	(8,640)	7,848
Change in advances to customers	(15,454)	(21,766)
Change in other assets	(1,070)	(3,474)
Change in financial liabilities designated at fair value	8	5
Change in current, savings and other deposit accounts	74,186	15,530
Change in deposits from banks	(6,566)	(8,300)
Change in trading liabilities	(9,891)	131
Change in certificates of deposit and other debt securities in issue	(946)	(2,913)
Change in other liabilities	4,048	7,150
Elimination of exchange differences and other non-cash items	(5,523)	4,542
<b>Cash generated from/(used in) operating activities</b>	<b>67,736</b>	<b>(83,616)</b>
Taxation paid	(1,921)	(3,214)
<b>Net cash inflow/(outflow) from operating activities</b>	<b>65,815</b>	<b>(86,830)</b>

(b) Analysis of the balances of cash and cash equivalents

	2009	2008
Cash and balances with banks and other financial institutions	22,086	24,822
Placings with and advances to banks and other financial institutions maturing within one month	74,459	44,572
Treasury bills	40,214	6,722
	<b>136,759</b>	<b>76,116</b>

The balances of cash and cash equivalents included cash balances with central banks and financial institutions that are subject to exchange control and regulatory restrictions, amounting to HK\$8,410 million at 31 December 2009 (2008: HK\$5,085 million).

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**55 Contingent liabilities and commitments**

The tables below give the contract amounts, credit equivalent amounts and risk-weighted amounts of off-balance sheet transactions. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

For the purposes of these financial statements, acceptances and endorsements are recognised on the statements of financial position in "Other assets" and "Other liabilities" in accordance with HKAS 39. For the purpose of the Banking (Capital) Rules ("the Capital Rules"), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables for the Group and the Bank were HK\$3,584 million (2008: HK\$3,090 million) and HK\$2,435 million (2008: HK\$2,255 million) respectively.

Contingent liabilities and commitments are credit-related instruments. The contract amounts represent the amounts at risk should the contracts be fully drawn upon and the customers default. Since a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Capital Rules and depend on the status of the counterparty and maturity characteristics of the instrument.

With the Capital Rules effective from 1 January 2007, the Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2009 were calculated based on the "advanced internal ratings-based approach" and the risk-weighted assets for 2008 were calculated based on the "foundation internal ratings-based approach".

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
<b>2009</b>						
Direct credit substitutes	3,121	2,987	1,785	3,121	2,987	1,785
Transaction-related contingencies	550	289	155	328	244	101
Trade-related contingencies	9,451	2,465	1,466	8,144	2,096	1,172
Forward asset purchases	36	36	36	36	36	36
Undrawn formal standby facilities, credit lines and other commitments to lend:						
- not unconditionally cancellable*	29,069	16,447	7,720	26,796	14,330	5,957
- unconditionally cancellable	158,817	53,514	15,036	147,079	50,369	12,603
	<u>201,044</u>	<u>75,738</u>	<u>26,198</u>	<u>185,504</u>	<u>70,062</u>	<u>21,654</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

55 Contingent liabilities and commitments (continued)

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2008						
Direct credit substitutes	4,174	4,174	2,132	4,174	4,174	2,132
Transaction-related contingencies	1,016	507	418	675	337	283
Trade-related contingencies	7,046	1,409	922	6,088	1,217	735
Forward asset purchases	59	59	59	59	59	59
Undrawn formal standby facilities, credit lines and other commitments to lend:						
- not unconditionally cancellable*	23,708	15,992	6,389	22,388	15,007	6,011
- unconditionally cancellable	155,505	30,971	3,586	147,415	30,971	3,586
	<u>191,508</u>	<u>53,112</u>	<u>13,506</u>	<u>180,799</u>	<u>51,765</u>	<u>12,806</u>

\* The contract amount for undrawn formal standby facilities, credit lines and other commitments to lend with original maturity of "not more than one year" and "more than one year" as at 31 December 2009 were HK\$13,371 million and HK\$15,698 million respectively (2008: HK\$10,444 million and HK\$13,264 million).

56 Assets pledged as security for liabilities

At 31 December 2009, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements for the Group and the Bank amounted to HK\$12,929 million (Group and Bank in 2008: HK\$9,807 million and HK\$8,766 million respectively). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK\$13,153 million (Group and Bank in 2008: HK\$10,110 million and HK\$9,069 million respectively) and mainly comprised items included in "Trading assets" and "Financial investments".

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

57 Capital commitments

	Group		Bank	
	2009	2008	2009	2008
Expenditure authorised and contracted for	<u>73</u>	<u>141</u>	<u>65</u>	<u>138</u>
Expenditure authorised but not contracted for	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>



NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Lease commitments

The Group leases certain properties and equipment under operating leases. The leases typically run for an initial period of one to five years and may include an option to renew the lease when all terms are renegotiated. None of these leases includes contingent rentals.

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

	Group		Bank	
	2009	2008	2009	2008
Within one year	414	398	296	284
Between one and five years	360	497	256	361
Over five years	-	2	-	-
	<u>774</u>	<u>897</u>	<u>552</u>	<u>645</u>

59 Employee retirement benefits

(a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 50 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS were closed to new entrants with effect from 31 December 1986.

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The Group makes contributions to these schemes in accordance with the recommendation of qualified actuary based on annual actuarial valuations. The latest annual actuarial valuations at 31 December 2009 were performed by E Chiu, fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) Ltd, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method. The amounts recognised in the statement of financial position at year-end and retirement benefits costs recognised in the income statement for the year in respect of these defined benefit schemes are set out below.

(i) The amounts recognised in the statements of financial position are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2009</b>			
Present value of funded obligations (note 59(a)(iii))	(5,557)	(170)	(2)
Fair value of scheme assets (note 59(a)(iv))	3,845	225	33
Net (liabilities)/assets recognised in the statement of financial position (note 59(a)(v))	<u>(1,712)</u>	<u>55</u>	<u>31</u>
Reported as "Assets"	-	55	31
Reported as "Liabilities"	<u>(1,712)</u>	<u>-</u>	<u>-</u>
	<u>(1,712)</u>	<u>55</u>	<u>31</u>
Obligations covered by scheme assets (%)	<u>69</u>	<u>132</u>	<u>1,650</u>
<b>2008</b>			
Present value of funded obligations (note 59(a)(iii))	(6,961)	(219)	(3)
Fair value of scheme assets (note 59(a)(iv))	3,430	218	33
Net (liabilities)/assets recognised in the statement of financial position (note 59(a)(v))	<u>(3,531)</u>	<u>(1)</u>	<u>30</u>
Reported as "Assets"	-	-	30
Reported as "Liabilities"	<u>(3,531)</u>	<u>(1)</u>	<u>-</u>
	<u>(3,531)</u>	<u>(1)</u>	<u>30</u>
Obligations covered by scheme assets (%)	<u>49</u>	<u>100</u>	<u>1,100</u>

The Occupational Retirement Schemes Ordinance (Cap.426 of the laws of Hong Kong) ("the Ordinance") requires that registered retirement benefit schemes shall at all time be fully funded to meet its aggregate vested liability (i.e. on a wind-up basis) in accordance with the recommendations contained in an actuarial certificate supplied under the Ordinance. Any shortfall must be made up within the specified time under the Ordinance. Any deficits to meet the aggregate past service liability (i.e. on an on-going basis) can however be eliminated over a period of time in accordance with the funding

NOTES TO THE FINANCIAL STATEMENTS (continued)

59 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

On an on-going basis, the actuarial value of the principal scheme assets of HSBDBS represented 100 per cent (2008: 89 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting surplus amounted to HK\$14 million (deficit in 2008: HK\$453 million). On a wind-up basis, the actuarial value of the scheme assets represented 100 per cent (2008: 90 per cent) of the members' vested benefits, based on salaries at that date, and the resulting surplus amounted to HK\$19 million (deficit in 2008: HK\$379 million).

(ii) The composition of the scheme assets are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2009</b>			
Equity	945	28	-
Bonds	2,724	171	-
Certificates of deposit issued by the Bank	-	-	-
Ordinary shares issued by ultimate holding company	48	-	-
Other	128	26	33
	<u>3,845</u>	<u>225</u>	<u>33</u>
2008			
Equity	787	15	-
Bonds	2,055	162	-
Certificates of deposit issued by the Bank	-	-	-
Ordinary shares issued by ultimate holding company	44	-	-
Other	544	41	33
	<u>3,430</u>	<u>218</u>	<u>33</u>

(iii) Change in the present value of scheme obligations

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2009</b>			
At 1 January	6,961	219	3
Current service cost	349	-	-
Interest cost	82	3	-
Actuarial gains	(1,491)	(37)	(1)
Benefits paid	(344)	(15)	-
At 31 December	<u>5,557</u>	<u>170</u>	<u>2</u>
2008			
At 1 January	5,722	188	3
Current service cost	296	-	-
Interest cost	195	6	-
Actuarial losses	987	40	-
Benefits paid	(239)	(15)	-
At 31 December	<u>6,961</u>	<u>219</u>	<u>3</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

59 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

(iv) Change in the fair value of scheme assets

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2009</b>			
At 1 January	3,430	218	33
Contributions by the Bank	212	-	-
Expected return on scheme assets	211	9	1
Experience gains/(losses)	336	13	(1)
Benefits paid	(344)	(15)	-
At 31 December	<u>3,845</u>	<u>225</u>	<u>33</u>
<b>2008</b>			
At 1 January	5,089	267	32
Contributions by the Bank	143	-	-
Expected return on scheme assets	382	10	1
Experience losses	(1,945)	(44)	-
Benefits paid	(239)	(15)	-
At 31 December	<u>3,430</u>	<u>218</u>	<u>33</u>

The Group and the Bank expect to make HK\$188 million of contributions to defined benefit schemes during the following year (2008: HK\$400 million).

(v) Movements in the net (liabilities)/assets recognised in the statements of financial position are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2009</b>			
At 1 January	(3,531)	(1)	30
Contributions by the Bank	212	-	-
Net (expense)/income recognised in the income statement (note 59(a)(vi))	(220)	6	1
Net actuarial gains	1,827	50	-
At 31 December	<u>(1,712)</u>	<u>55</u>	<u>31</u>
Experience gains on scheme liabilities	288	5	-
Experience gains/(losses) on scheme assets	336	13	(1)
Gains from change in actuarial assumptions	1,203	32	1
Net actuarial gains	<u>1,827</u>	<u>50</u>	<u>-</u>
<b>2008</b>			
At 1 January	(633)	79	29
Contributions by the Bank	143	-	-
Net (expense)/income recognised in the income statement (note 59(a)(vi))	(109)	4	1
Net actuarial losses	(2,932)	(84)	-
At 31 December	<u>(3,531)</u>	<u>(1)</u>	<u>30</u>
Experience gains on scheme liabilities	258	2	-
Experience losses on scheme assets	(1,945)	(44)	-
Losses from change in actuarial assumptions	(1,245)	(42)	-
Net actuarial losses	<u>(2,932)</u>	<u>(84)</u>	<u>-</u>

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**59 Employee retirement benefits** (continued)

**(a) Defined benefit schemes** (continued)

(vi) Amounts recognised in the income statement are as follows:

	Group		
	HSBDBS	HSBPS	HSBNTBS
<b>2009</b>			
Current service cost	(349)	-	-
Interest cost	(82)	(3)	-
Expected return on scheme assets	211	9	1
Net (expense)/income for the year (note 17)	<u>(220)</u>	<u>6</u>	<u>1</u>
Actual return on scheme assets	<u>547</u>	<u>22</u>	<u>-</u>
<b>2008</b>			
Current service cost	(296)	-	-
Interest cost	(195)	(6)	-
Expected return on scheme assets	382	10	1
Net (expense)/income for the year (note 17)	<u>(109)</u>	<u>4</u>	<u>1</u>
Actual return on scheme assets	<u>(1,563)</u>	<u>(33)</u>	<u>-</u>

The net actuarial gains recognised in the Group's retained profit during 2009 in respect of defined benefit schemes were HK\$1,568 million (net actuarial losses of HK\$2,529 million during 2008). The total cumulative amount of actuarial losses recognised in the retained profit was HK\$1,911 million (2008: the cumulative amount of actuarial losses was HK\$3,479 million). The total effect of the limit on schemes surpluses in 2009 and 2008 in respect of defined benefit schemes was HK\$ nil.

(vii) The principal actuarial assumptions used as at 31 December (expressed as weighted averages) are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2009</b>	%	%	%
Discount rate	2.6	2.6	2.6
Expected rate of return on scheme assets	5.5	4.0	3.0
Expected rate of salary increases	5.0	5.0	5.0
Expected rate of pension increases	-	1.0	-
<b>2008</b>	%	%	%
Discount rate	1.2	1.2	1.2
Expected rate of return on scheme assets	6.0	4.0	3.0
Expected rate of salary increases	5.0	5.0	5.0
Expected rate of pension increases	-	1.5	-

The expected rate of return on scheme assets represents the best estimate of long-term future asset returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates.

NOTES TO THE FINANCIAL STATEMENTS (continued)

59 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

(viii) Amounts for the current and previous years

	Group and Bank				
	2009	2008	2007	2006	2005
Defined benefit obligations	5,729	7,183	5,913	3,905	3,742
Plan assets	4,103	3,681	5,388	4,728	4,199
Net (deficits)/surpluses	(1,626)	(3,502)	(525)	823	457
Experience gains/(losses) on scheme liabilities	293	260	(212)	(36)	19
Experience gains/(losses) on scheme assets	348	(1,989)	416	413	68
Gains/(losses) from change in actuarial assumptions	1,236	(1,287)	(1,711)	(113)	104

(b) Defined contribution schemes

The principal defined contribution scheme for Group employees joining on or after 1 April 1999 is the HSBC Group Hong Kong Local Staff Defined Contribution Scheme. The Group also operates three other defined contribution schemes, the Hang Seng Bank Provident Fund Scheme which was closed to new entrants since 31 December 1986, the Hang Seng Insurance Company Limited Employees' Provident Fund and the Hang Seng Bank (Bahamas) Limited Defined Contribution Scheme for employees of the respective subsidiaries. The Bank and relevant Group entities also participated in mandatory provident fund schemes ("MPF schemes") registered under the Hong Kong Mandatory Provident Fund Ordinance, which are also defined contribution schemes.

Contributions made in accordance with the relevant scheme rules to these defined contribution schemes (including MPF schemes) are charged to the income statement as below:

	2009	2008
Amounts charged to the income statement (note 17)	<u>74</u>	<u>69</u>

Under the Schemes, the Group's contributions are reduced by contributions forfeited by those employees who leave the Schemes prior to the contributions vesting fully. There was no forfeited contributions utilised during the year or available at the year-end to reduce future contributions (2008: Nil).

60 Share-based payments

The Group participated in various share compensation plans operated by the HSBC Group for acquiring of HSBC Holdings plc shares. They are the Savings-Related Share Option Plan, Executive / Group Share Option Plan and Restricted Share Plan/Performance Share Awards/Achievement Share Awards. These are to be settled by the delivery of shares of HSBC Holdings plc.

(a) Savings-Related Share Option Plan

The Savings-Related Share Option Plan, invites eligible employees to enter into savings contracts to save Hong Kong dollar equivalent of up to £250 per month, with the option to use the savings to acquire shares. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year savings contract depending on conditions set at grant. There is generally one Savings-Related Share Option Plan grant each year (in April or May). The exercise price is at a 20 per cent (2008: 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 TO THE FINANCIAL STATEMENTS (continued)

60 Share-based payments (continued)

(a) Savings-Related Share Option Plan (continued)

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

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

	2009		2008	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	6.55	543	6.43	1,922
Exercised in the year	5.64	(171)	6.36	(1,235)
Lapsed in the year	6.55	(387)	6.43	(144)
Adjustment for rights issue	5.69	44	-	-
Outstanding at 31 December	5.82	<u>29</u>	6.55	<u>543</u>
Exercisable at 31 December	-	<u>-</u>	6.68	<u>2</u>

The weighted average share price at the date of exercise for share options exercised during the year was £6.56 (2008: £8.44).

The options outstanding at the year end had an exercise price of £5.82 (2008: £6.47 to £6.68), and a weighted average remaining contractual life of 1.08 years (2008: 1.45 years).

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

	2009		2008	
	Weighted average exercise price HK\$	Number ('000)	Weighted average exercise price HK\$	Number ('000)
Outstanding at 1 January	106.14	2,296	106.73	3,363
Granted in the year	37.88	12,292	106.25	2,034
Exercised in the year	90.14	(11)	108.45	(584)
Lapsed in the year	102.99	(2,526)	106.73	(2,517)
Adjustment for rights issue	92.30	142	-	-
Outstanding at 31 December	38.30	<u>12,193</u>	106.14	<u>2,296</u>
Exercisable at 31 December	-	<u>-</u>	-	<u>-</u>

The weighted average share price at the date of exercise for share options exercised during the year was HK\$83.33 (2008: HK\$124.65).

The options outstanding at the year end had an exercise price in the range of HK\$37.88 to HK\$94.51 (2008: HK\$103.44 to HK\$108.45), and a weighted average remaining contractual life of 3.50 years (2008: 2.17 years).

The weighted average fair value of options granted during the year was HK\$15.74 (2008: HK\$29.42).

NOTES TO THE FINANCIAL STATEMENTS (continued)

60 Share-based payments (continued)

(b) Executive / Group Share Option Plan

Executive Share Option Plan (for options granted in 1999 and 2000) and Group Share Option Plan (for options granted in 2001 to 2004), were issued by the HSBC Holdings plc and awarded to high performing employees of the Group on a discretionary basis. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. Exercise of the options, is also subject to the attainment of a corporate performance condition. The Group Share Option Plan has been closed since 2004.

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

	2009		2008	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	7.93	2,747	7.89	2,976
Exercised in the year	7.55	(60)	7.03	(158)
Lapsed in the year	7.93	(441)	7.89	(71)
Adjustment for rights issue	6.99	406	-	-
Outstanding at 31 December	7.04	<u>2,652</u>	7.93	<u>2,747</u>
Exercisable at 31 December	7.04	<u>2,652</u>	7.93	<u>2,747</u>

The weighted average share price at the date of exercise for share options exercised during the year was £5.86 (2008: £7.99).

The options outstanding at the year end had an exercise price in the range of £6.02 to £7.59 (2008: £6.38 to £8.71), and a weighted average remaining contractual life of 2.89 years (2008: 3.56 years).

(c) Calculation of fair value

The recognition of compensation cost of share option is based on the fair value of the options on grant date. The calculation of the fair value of HSBC share option is centrally managed by HSBC Holdings plc. Fair values of share options, measured at the date of grant of the options are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. Expected dividends are incorporated into the valuation model for share options and awards where applicable. 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 values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

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

	1-year Savings-Related Share Option Plan	3-year Savings-Related Share Option Plan	5-year Savings-Related Share Option Plan
<b>2009</b>			
Risk-free interest rate (%)	0.7	2.1	2.4
Expected life (years)	1	3	5
Expected volatility (%)	50	35	30
Share price at grant date (HK\$)	53.34	53.34	53.34
<b>2008</b>			
Risk-free interest rate (%)	4.5	4.5	4.5
Expected life (years)	1	3	5
Expected volatility (%)	25	25	25
Share price at grant date (HK\$)	136.23	136.23	136.23

NOTES TO THE FINANCIAL STATEMENTS (continued)

60 Share-based payments (continued)

(c) Calculation of fair value (continued)

The risk-free rate was determined from the UK gilts yield curve for Savings-Related Share Option Plan. Expected life is not a single input parameter but a function of various behavioural assumptions. Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options. Expected dividend yield was based on historic levels of dividend growth.

(d) Restricted Share Plan / Performance Share Awards / Achievement Share Awards

Restricted shares, which operated from 1996 to 2004, were granted with vesting criteria subject to attaining the HSBC Group targets. Since 2005, performance share awards are made to the Group's most senior executives taking into account individual performance in the year. The share awards are divided into two criteria for testing attainment against pre-determined benchmarking. One half is subject to a Total Shareholder Return measure and the other half of the award is subject to an Earnings Per Share target. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if the minimum criteria are failed to meet.

Achievement shares were launched in 2005 and are awarded to eligible employees after taking into account of the employee's performance in the year. 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. The fair value of the shares awarded is charged to the income statement as share compensation cost over the period from issue date to release date.

	2009	2008
	Number (‘000)	Number (‘000)
Outstanding at 1 January	917	500
Additions during the year	181	462
Released in the year	(141)	(45)
Outstanding at 31 December	<u>957</u>	<u>917</u>

The closing price of the HSBC Holdings plc share at 31 December 2009 was £7.09 (2008: £6.62).

The weighted average remaining vesting period as at 31 December 2009 was 1.33 years (2008: 1.86 years).

(e) Employee expenses

During 2009, HK\$101 million was charged to the income statement in respect of share-based payment transactions settled in equity (2008: HK\$109 million). This expense, which was computed from the fair values of the share-based payment transactions when granted, arose under employee share awards made in accordance with the Group's reward structures.



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 61 Material related-party transactions

#### (a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates

In 2009, the Group entered into transactions with its immediate holding company and its subsidiaries and fellow subsidiary companies in the ordinary course of its interbank activities including lending activities, acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The Group used the IT service of, and shared an automated teller machine network with, its immediate holding company. The Group also shared certain IT projects with and used certain processing services of fellow subsidiaries on a cost recovery basis. The Group maintained a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. A fellow subsidiary company was appointed as fund manager to manage the Group's investment portfolios. The Bank acted as agent for the marketing of Mandatory Provident Fund products and the distribution of retail investment funds for two fellow subsidiary companies.

There was an arrangement whereby a fellow subsidiary provided certain management services, being services related to risk management, back office processing and administration, development and pricing of selected products, information technology and business recovery, financial control and actuarial services, to Hang Seng Insurance Company Limited. The premiums, commissions and other fees on these transactions are determined on an arm's length basis.

The aggregate amount of income and expenses arising from these transactions during the year, the balances of amounts due to and from the relevant related parties, and the total contract sum of off-balance sheet transactions at the year-end are as follows:

	Group					
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Associates	
	2009	2008	2009	2008	2009	2008
Interest income	245	315	-	57	2	1
Interest expense	(43)	(314)	(3)	(12)	(3)	(13)
Other operating income/(expense)	17	(52)	1	12	2	2
Operating expenses*	(736)	(696)	(415)	(388)	(12)	(13)
<b>Amounts due from:</b>						
Cash and balances with banks and other financial institutions	1,495	6,765	758	267	13	245
Placings with and advances to banks and other financial institutions	10,841	10,899	-	-	-	-
Derivative financial instruments	373	602	10	33	-	-
Financial assets designated at fair value	3,346	3,545	-	-	-	-
Advances to customers	-	-	-	-	233	233
Financial investments	412	692	-	-	-	-
Other assets	55	108	10	118	3	3
	<u>16,522</u>	<u>22,611</u>	<u>778</u>	<u>418</u>	<u>249</u>	<u>481</u>
<b>Amounts due to:</b>						
Current, savings and other deposit accounts	1,527	36	126	141	63	51
Deposits from banks	1,309	5,478	4	-	116	441
Derivative financial instruments	1,238	7,390	76	35	-	-
Subordinated liabilities	2,017	2,015	-	-	-	-
Other liabilities	246	194	84	80	-	-
	<u>6,337</u>	<u>15,113</u>	<u>290</u>	<u>256</u>	<u>179</u>	<u>492</u>
<b>Derivative contracts:</b>						
Contract amount	46,180	136,269	18,280	8,593	-	-
<b>Guarantees:</b>						
Guarantees issued	-	4	-	-	116	-

\* 2009 Operating expenses included payment of HK\$107 million (2008: HK\$127 million) of software costs which were capitalised as intangible assets in the statement of financial position of the Group.

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**61 Material related-party transactions** (continued)

**(a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates** (continued)

	<b>Bank</b>							
	<b>Immediate holding company and its subsidiaries</b>		<b>Fellow subsidiaries</b>		<b>Subsidiaries</b>		<b>Associates</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Amounts due from:</b>								
Cash and balances with banks and other financial institutions	1,397	6,724	701	261	-	-	-	-
Placings with and advances to banks and other financial institutions	5,196	6,192	-	-	-	-	-	-
Derivative financial instruments	280	592	10	33	1	62	-	-
Financial assets designated at fair value	-	-	-	-	-	-	-	-
Advances to customers	-	-	-	-	-	-	-	-
Amounts due from subsidiaries	-	-	-	-	87,360	84,907	-	-
Financial investments	-	-	-	-	-	-	-	-
Other assets	17	59	5	94	-	-	3	3
	<u>6,890</u>	<u>13,567</u>	<u>716</u>	<u>388</u>	<u>87,361</u>	<u>84,969</u>	<u>3</u>	<u>3</u>
<b>Amounts due to:</b>								
Current, savings and other deposit accounts	1,527	36	126	141	-	-	63	51
Deposits from banks	1,309	4,958	4	-	-	-	116	-
Derivative financial instruments	1,230	7,379	75	35	18	74	-	-
Subordinated liabilities	2,017	2,015	-	-	-	-	-	-
Amounts due to subsidiaries	-	-	-	-	9,960	8,575	-	-
Other liabilities	194	162	82	75	-	-	-	-
	<u>6,277</u>	<u>14,550</u>	<u>287</u>	<u>251</u>	<u>9,978</u>	<u>8,649</u>	<u>179</u>	<u>51</u>
<b>Derivative contracts:</b>								
Contract amount	40,975	135,420	18,280	8,593	12,220	3,636	-	-
<b>Guarantees:</b>								
Guarantees issued	-	4	-	-	543	564	116	-
Guarantees received	-	-	-	-	142	10	-	-

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 61 Material related-party transactions (continued)

#### (b) Key management personnel remuneration

Remuneration for key management personnel, including amounts paid to the Bank's directors as disclosed in note 19 and highest paid employees as disclosed in note 18, is as follows:

	Group		Bank	
	2009	2008	2009	2008
Employee benefits	39	51	39	51
Post-employment benefits	5	5	5	5
Share-based payments	6	8	6	8
	<u>50</u>	<u>64</u>	<u>50</u>	<u>64</u>

#### (c) Material transactions with key management personnel

During the year, the Group provided credit facilities to and accepted deposits from key management personnel of the Bank and its holding companies, their close family members and companies controlled or significantly influenced by them. The credit facilities extended and deposit taken were provided in the ordinary course of business and on substantially the same terms as for comparable transactions with persons of a similar standing or, where applicable, with other employees.

Material transactions conducted with key management personnel of the Bank and its holding companies and parties related to them are as follows:

	Group		Bank	
	2009	2008	2009	2008
Interest received	232	444	230	432
Interest paid	5	137	5	137
Fees and exchange income received	16	20	16	20
Loans and advances	9,834	17,749	9,254	16,385
Deposits	2,096	5,348	2,085	5,348
Undrawn commitments	3,206	4,182	3,167	4,182
Maximum aggregate amount of loans and advances during the year	<b>21,401</b>	21,020	<b>19,836</b>	19,424

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

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

#### (d) Loans to officers

Loans to officers of the Bank disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

	Group		Bank	
	2009	2008	2009	2008
Aggregate amount of relevant transactions outstanding at 31 December	<u>73</u>	<u>50</u>	<u>69</u>	<u>45</u>
Maximum aggregate amount of relevant transactions during the year	<u>132</u>	<u>174</u>	<u>127</u>	<u>168</u>

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 61 Material related-party transactions *(continued)*

#### (e) Associates

Information relating to associates and transactions with associates can be found in notes 38 and 61(a).

The Group maintains a shareholders' loan to an associate. The shareholders' loan is unsecured, interest free and with no fixed term of repayment. The balance at 31 December 2009 was HK\$233 million (2008: HK\$233 million).

The Bank has been assisting Industrial Bank Co., Ltd. in managing and growing the credit card business, and providing support in the issuance of dual-logo credit cards.

The Bank has entered into Technical Support Agreement with Yantai Bank Co., Ltd. ("Yantai Bank") to provide technical support and assistance in relation to various banking operations and businesses of Yantai Bank.

#### (f) Ultimate holding company

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 60, 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 2009 amounted to HK\$446 million comprising HK\$445 million relating to share option schemes and HK\$1 million relating to share award schemes (2008: HK\$411 million comprising HK\$371 million relating to share option schemes and HK\$40 million relating to share award schemes).

#### (g) Employee retirement benefits

At 31 December 2009, defined benefit scheme assets amounted to HK\$1,341 million (2008: HK\$1,387 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK\$10 million (2008: HK\$4 million).

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### 62 Financial risk management

This section presents information about the Group's management and control of risks, in particular, those associated with its use of financial instruments ("financial risks"). Major types of financial risks to which the Group was exposed include credit risk, liquidity risk, market risk, insurance risk and operational risk.

The Group's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks and limits continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major control limits are approved by the Board of Directors and they are monitored and reviewed regularly by various management committees, including the Executive Committee, Audit Committee, Asset and Liability Management Committee ("ALCO"), Credit Committee and Risk Management Committee ("RMC") which was set up in July 2008 to centralise the risk management oversight function of the Bank and to review, analyse, evaluate, recognise and manage various risks of the Bank. RMC is constituted by the Board but reports to Executive Committee.

There are existing approval procedures for the launch of new business and products. The procedures include due diligence which are signed off by major operational and control (including compliance, credit, legal, tax, financial, IT development and corporate communication) functions, reviewed by senior executives and approved by at least 2 ALCO members. ALCO is also required to formally endorse the launch of new products. In addition, RMC also reviews the new services and activities approved by ALCO from risk management perspective. Each new business and product launch is also subject to an operational risk self-assessment process, which includes identification, evaluation and mitigation of risk arising from the new initiative. Internal Audit is consulted on the internal control aspect of new product and business in development prior to implementation.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (a) Credit risk

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, treasury and leasing businesses. The Group has dedicated standards, policies and procedures in place to control and monitor risk from all such activities.

The Credit Risk Management (CRM) function headed by the Chief Risk Officer is mandated to provide centralised management of credit risk through:

- formulating credit policies on approval process, post disbursement monitoring, recovery process and large exposure;
- issuing guidelines on lending to specified market sectors, industries and products; the acceptability of specific classes of collateral or risk mitigations and valuation parameters for collateral;
- undertaking an independent review and objective assessment of credit risk for all commercial non-bank credit facilities in excess of designated amount prior to the facilities being committed to customers;
- controlling exposures to selected industries, counterparties, countries and portfolio types etc by setting limits;
- maintaining and developing credit risk rating/facility grading process to categorise exposures and facilitate focused management;
- reporting to senior executives and various committees on aspects of the Group loan portfolio;
- managing and directing credit-related systems initiatives; and
- providing advice and guidance to business units on various credit-related issues.

#### Impairment loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loans impairment allowances are made promptly where necessary and need to be consistent with established guidelines. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Management regularly performs an assessment of the adequacy of the established impairment provisions by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions.

#### Risk rating framework

A more sophisticated risk rating framework on counterparty credit risk based on default probability and loss estimates is being implemented across the Group. The rating methodology of this framework is based upon a wide range of financial analytics. This new approach will allow a more granular analysis of risk and trends. The information generated from the risk rating framework is used but not limited to credit approval, credit monitoring, pricing, loan classification and capital adequacy assessment. The Bank also has control mechanisms in place to validate the performance and accuracy of the risk rating framework.

To measure and manage the risk in these exposures, both to individually assessed customers and to those aggregated into portfolios, the Group employs diverse risk rating systems and methodologies.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (a) Credit risk *(continued)*

##### **Collateral and other credit enhancements**

The Group has implemented guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determined the valuation parameters. Such parameters are established prudently and are reviewed regularly in light of changing market environment and empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfill their intended purpose and remain in line with local market practice. While collateral is an important mitigant to credit risk, it is the Group's policy to establish that loans are within the customer's capacity to repay rather than to rely excessively on security. Facilities may be granted on unsecured basis depending on the customer's standing and the type of product. The principal collateral types are as follows:

- in the personal sector, charges over the properties, securities, investment funds and deposits;
- in the commercial and industrial sector, charges over business assets such as properties, stock, debtors, investment funds, deposits and machinery;
- in the commercial real estate sector, charges over the properties being financed.

Repossessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the statement of financial position within "Other assets" at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance). If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The Group does not generally occupy repossessed properties for its business use.

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.

##### **Settlement risk**

Settlement risk arises 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 to cover the settlement risk arising from the Group's trading 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.

The ISDA Master Agreement is the Group's preferred agreement for documenting derivative activities. It provides the contractual framework that a full range of over-the-counter ("OTC") products is conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement, if either party defaults or following other pre-agreed termination events.

##### **Concentration of credit risk**

Concentration of credit risk exists when changes in geographic, economic or industry factors similarly affect groups of counterparties whose aggregate credit exposure is material in relation to the Group's total exposures. The Group's portfolio of financial instrument is diversified along geographic, industry and product sectors. Analysis of geographical concentration of the Group's assets is disclosed in note 27 to the financial statements and credit risk concentration of respective financial assets is disclosed in notes 32, 33, 35 and 36.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

The below analysis shows the exposures to credit risk in accordance with HKFRS 7 "Financial Instruments: Disclosures".

#### (i) Maximum exposure to credit risk before collateral held or other credit enhancements

	Group		Bank	
	2009	2008	2009	2008
Cash and balances with banks and other financial institutions	22,086	24,822	18,461	22,071
Placings with and advances to banks and other financial institutions	104,551	69,579	65,624	38,097
Trading assets	66,597	108,389	65,288	107,775
Financial assets designated at fair value	5,450	7,798	174	830
Derivative financial instruments	5,050	7,104	4,916	6,910
Advances to customers	344,621	329,121	299,179	280,255
Financial investments	241,502	181,159	156,715	112,000
Amounts due from subsidiaries	-	-	87,360	84,907
Other assets	10,726	11,123	8,040	8,627
Financial guarantees and other credit related contingent liabilities	9,137	8,744	9,294	8,682
Loan commitments and other credit related commitments	295,084	285,507	280,093	273,210
	<u>1,104,804</u>	<u>1,033,346</u>	<u>995,144</u>	<u>943,364</u>

#### (ii) Credit quality

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 and all EL 1 to EL 8 exposures past due 90 days and above	Individually identified

\* All retail exposures past due 90 days and above are classified as "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 process.

- 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 4 on the financial statements. Analysis of impairment allowances as at 31 December 2009 and the movement of such allowances during the year are disclosed in note 35.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

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 debt securities 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 income statement. Consequently, all such balances are reported under "neither past due nor impaired".

#### Distribution of financial instruments by credit quality

	Neither past due nor impaired			Group			Total
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	
<b>2009</b>							
Items in the course of collection from other banks	4,343	-	-	-	-	-	4,343
Trading assets:							
- treasury and eligible bills	62,028	-	-	-	-	-	62,028
- debt securities	4,562	-	-	-	-	-	4,562
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	1	-	-	-	-	1
	<u>66,590</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>66,591</u>
Financial assets designated at fair value:							
- treasury and eligible bills	-	-	-	-	-	-	-
- debt securities	4,841	86	-	-	-	-	4,927
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-	-
	<u>4,841</u>	<u>86</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,927</u>
Derivatives	4,050	983	17	-	-	-	5,050
Loans and advances held at amortised cost:							
- loans and advances to banks	115,838	6,500	-	-	-	-	122,338
- loans and advances to customers	196,834	138,333	4,797	4,114	2,508	(1,965)	344,621
	<u>312,672</u>	<u>144,833</u>	<u>4,797</u>	<u>4,114</u>	<u>2,508</u>	<u>(1,965)</u>	<u>466,959</u>
Financial investments:							
- treasury and similar bills	53,973	-	-	-	-	-	53,973
- debt securities	177,926	9,256	-	-	-	-	187,182
	<u>231,899</u>	<u>9,256</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>241,155</u>
Other assets:							
- acceptances and endorsements	877	2,576	131	-	-	-	3,584
- other	1,792	968	34	5	-	-	2,799
	<u>2,669</u>	<u>3,544</u>	<u>165</u>	<u>5</u>	<u>-</u>	<u>-</u>	<u>6,383</u>



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

	Group							Total
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances		
	Strong	Medium*	Sub- standard					
2008								
Items in the course of collection from other banks	4,028	-	-	-	-	-	4,028	
Trading assets:								
- treasury and eligible bills	103,621	-	-	-	-	-	103,621	
- debt securities	4,530	220	-	-	-	-	4,750	
- loans and advances to banks	-	-	-	-	-	-	-	
- loans and advances to customers	-	18	-	-	-	-	18	
	<u>108,151</u>	<u>238</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>108,389</u>	
Financial assets designated at fair value:								
- treasury and eligible bills	-	-	-	-	-	-	-	
- debt securities	7,194	242	-	-	-	-	7,436	
- loans and advances to banks	-	-	-	-	-	-	-	
- loans and advances to customers	-	-	-	-	-	-	-	
	<u>7,194</u>	<u>242</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>7,436</u>	
Derivatives	5,916	1,137	51	-	-	-	7,104	
Loans and advances held at amortised cost:								
- loans and advances to banks	87,724	2,981	-	-	-	-	90,705	
- loans and advances to customers	199,384	115,184	6,355	6,837	3,404	(2,043)	329,121	
	<u>287,108</u>	<u>118,165</u>	<u>6,355</u>	<u>6,837</u>	<u>3,404</u>	<u>(2,043)</u>	<u>419,826</u>	
Financial investments:								
- treasury and similar bills	9,927	-	-	-	-	-	9,927	
- debt securities	158,655	11,983	-	-	160	-	170,798	
	<u>168,582</u>	<u>11,983</u>	<u>-</u>	<u>-</u>	<u>160</u>	<u>-</u>	<u>180,725</u>	
Other assets:								
- acceptances and endorsements	775	2,237	74	-	4	-	3,090	
- other	3,032	946	16	11	-	-	4,005	
	<u>3,807</u>	<u>3,183</u>	<u>90</u>	<u>11</u>	<u>4</u>	<u>-</u>	<u>7,095</u>	

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

	Neither past due nor impaired			Bank			Total
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	
<b>2009</b>							
Items in the course of collection from other banks	4,343	-	-	-	-	-	4,343
Trading assets:							
- treasury and eligible bills	62,028	-	-	-	-	-	62,028
- debt securities	3,253	-	-	-	-	-	3,253
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	1	-	-	-	-	1
	<u>65,281</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>65,282</u>
Financial assets designated at fair value:							
- treasury and eligible bills	-	-	-	-	-	-	-
- debt securities	174	-	-	-	-	-	174
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-	-
	<u>174</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>174</u>
Derivatives	3,930	971	15	-	-	-	4,916
Loans and advances held at amortised cost:							
- loans and advances to banks	76,150	3,856	-	-	-	-	80,006
- loans and advances to customers	170,878	122,500	2,779	2,924	1,761	(1,663)	299,179
	<u>247,028</u>	<u>126,356</u>	<u>2,779</u>	<u>2,924</u>	<u>1,761</u>	<u>(1,663)</u>	<u>379,185</u>
Financial investments:							
- treasury and similar bills	49,277	-	-	-	-	-	49,277
- debt securities	101,905	5,386	-	-	-	-	107,291
	<u>151,182</u>	<u>5,386</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>156,568</u>
Other assets:							
- acceptances and endorsements	763	1,641	31	-	-	-	2,435
- other	974	282	2	4	-	-	1,262
	<u>1,737</u>	<u>1,923</u>	<u>33</u>	<u>4</u>	<u>-</u>	<u>-</u>	<u>3,697</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

	Neither past due nor impaired			Bank			Total
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	
2008							
Items in the course of collection from other banks	4,017	-	-	-	-	-	4,017
Trading assets:							
- treasury and eligible bills	103,463	-	-	-	-	-	103,463
- debt securities	4,074	220	-	-	-	-	4,294
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	18	-	-	-	-	18
	<u>107,537</u>	<u>238</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>107,775</u>
Financial assets designated at fair value:							
- treasury and eligible bills	-	-	-	-	-	-	-
- debt securities	830	-	-	-	-	-	830
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-	-
	<u>830</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>830</u>
Derivatives	5,722	1,137	51	-	-	-	6,910
Loans and advances held at amortised cost:							
- loans and advances to banks	54,929	1,751	-	-	-	-	56,680
- loans and advances to customers	172,761	97,222	5,260	4,721	2,032	(1,741)	280,255
	<u>227,690</u>	<u>98,973</u>	<u>5,260</u>	<u>4,721</u>	<u>2,032</u>	<u>(1,741)</u>	<u>336,935</u>
Financial investments:							
- treasury and similar bills	4,304	-	-	-	-	-	4,304
- debt securities	99,110	8,250	-	-	62	-	107,422
	<u>103,414</u>	<u>8,250</u>	<u>-</u>	<u>-</u>	<u>62</u>	<u>-</u>	<u>111,726</u>
Other assets:							
- acceptances and endorsements	683	1,494	74	-	4	-	2,255
- other	1,693	644	10	8	-	-	2,355
	<u>2,376</u>	<u>2,138</u>	<u>84</u>	<u>8</u>	<u>4</u>	<u>-</u>	<u>4,610</u>

\* Includes HK\$3,006 million (2008: HK\$7,917 million) and HK\$1,557 million (2008: HK\$6,296 million) of debt securities that have been classified as BBB- to BBB+ for the Group and the Bank respectively in 2009, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

#### **Aging analysis of financial instruments which were 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; loans fully secured by cash collateral; residential mortgages in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; 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					Total
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	
<b>2009</b>						
Items in the course of collection from other banks	-	-	-	-	-	-
Trading assets:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers <sup>#</sup>	<b>3,432</b>	<b>588</b>	<b>83</b>	<b>11</b>	-	<b>4,114</b>
	<u><b>3,432</b></u>	<u><b>588</b></u>	<u><b>83</b></u>	<u><b>11</b></u>	<u>-</u>	<u><b>4,114</b></u>
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	<b>4</b>	<b>1</b>	-	-	-	<b>5</b>
	<u><b>4</b></u>	<u><b>1</b></u>	<u>-</u>	<u>-</u>	<u>-</u>	<u><b>5</b></u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

	Group					Total
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	
2008						
Items in the course of collection from other banks	-	-	-	-	-	-
Trading assets:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers <sup>#</sup>	5,224	1,141	408	32	32	6,837
	<u>5,224</u>	<u>1,141</u>	<u>408</u>	<u>32</u>	<u>32</u>	<u>6,837</u>
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	8	2	1	-	-	11
	<u>8</u>	<u>2</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>11</u>

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**62 Financial risk management** (continued)

**(a) Credit risk** (continued)

(ii) Credit quality (continued)

	Bank					Total
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	
<b>2009</b>						
Items in the course of collection from other banks	-	-	-	-	-	-
Trading assets:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers <sup>#</sup>	<b>2,540</b>	<b>331</b>	<b>52</b>	<b>1</b>	-	<b>2,924</b>
	<u><b>2,540</b></u>	<u><b>331</b></u>	<u><b>52</b></u>	<u><b>1</b></u>	<u>-</u>	<u><b>2,924</b></u>
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	<b>3</b>	<b>1</b>	-	-	-	<b>4</b>
	<u><b>3</b></u>	<u><b>1</b></u>	<u>-</u>	<u>-</u>	<u>-</u>	<u><b>4</b></u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

	Bank					Total
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	
2008						
Items in the course of collection from other banks	-	-	-	-	-	-
Trading assets:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers <sup>#</sup>	3,843	648	173	28	29	4,721
	<u>3,843</u>	<u>648</u>	<u>173</u>	<u>28</u>	<u>29</u>	<u>4,721</u>
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	7	1	-	-	-	8
	<u>7</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>8</u>

#### <sup>#</sup> 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 4(f) to the financial statements.

Analyses of impairment allowances at 31 December 2009 and the movement of such allowances during the year are disclosed in note 35.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (a) Credit risk (continued)

##### (ii) Credit quality (continued)

*Renegotiated loans that would otherwise be past due or impaired*

Renegotiated loans are those that have been restructured due to deterioration in the borrower's financial position and where the Group has made concessions that it would not otherwise consider. Once the loan is restructured it remains in this category independent of satisfactory performance after restructuring.

	<b>Group</b>		<b>Bank</b>	
	<b>2009</b>	2008	<b>2009</b>	2008
Renegotiated loans that would otherwise be past due or impaired	<u>1,110</u>	<u>296</u>	<u>801</u>	<u>228</u>

##### (iii) Collateral and other credit enhancements obtained

During the years indicated, the Group obtained assets by taking possession of collateral held as security, or calling other credit enhancement, as follows:

	<b>Group</b>		<b>Bank</b>	
	<b>2009</b>	2008	<b>2009</b>	2008
Nature of assets:				
Residential properties	19	115	12	103
Commercial and industrial properties	-	14	-	14
Other	-	1	-	1
	<u>19</u>	<u>130</u>	<u>12</u>	<u>118</u>



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial 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 approximately balanced and all funding obligations are met when due.

It is the responsibility of the Group's management to ensure compliance with local regulatory requirements and limits set by Executive Committee. Liquidity is managed on a daily basis by the Bank's treasury functions and overseas treasury sites.

Compliance with liquidity requirements is monitored by the Asset and Liability Management Committee ("ALCO") and is reported to the Risk Management Committee, Executive Committee and the Board of Directors. 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 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
- monitoring of depositor concentration contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systematic 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 short notice, in practice short-term deposit balances remain stable as inflows and outflows broadly match.

The average liquidity ratio for the year, calculated in accordance with the Fourth Schedule of the Hong Kong Banking Ordinance, is as follows:

	<b>Group</b>	
	<b>2009</b>	2008
The Bank and its subsidiaries designated by the HKMA	<u><b>48.1%</b></u>	<u>46.4%</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (b) Liquidity risk (continued)

The following tables give the undiscounted cash-flow projection of the Group's financial liabilities including interest payable and undrawn commitments at the end of the reporting period based on the dates of their contractual payment obligations. Interest payable in respect of term financial liabilities are reported based on contractual interest payment date. Financial liabilities repayable on demand (such as savings and current deposits) including interest accrued up to the end of the reporting period are reported under the column "repayable on demand".

	Group					Total
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	
<b>At 31 December 2009</b>						
Current, savings and other deposit accounts	494,372	119,462	22,508	753	-	637,095
Deposits from banks	2,964	1,771	25	117	-	4,877
Financial liabilities designated at fair value	3	10	1,010	-	451	1,474
Trading liabilities	38,391	-	-	-	-	38,391
Derivative financial instruments	3,581	75	365	242	(8)	4,255
Certificates of deposit and other debt securities in issue	-	344	1,214	328	-	1,886
Other financial liabilities	5,881	4,935	1,103	114	116	12,149
Subordinated liabilities	-	12	3,547	5,846	-	9,405
	<u>545,192</u>	<u>126,609</u>	<u>29,772</u>	<u>7,400</u>	<u>559</u>	<u>709,532</u>
Commitments	7,410	31,823	13,493	157,443	11	210,180
Financial guarantee contracts	599	741	755	260	372	2,727
	<u>8,009</u>	<u>32,564</u>	<u>14,248</u>	<u>157,703</u>	<u>383</u>	<u>212,907</u>
<b>At 31 December 2008</b>						
Current, savings and other deposit accounts	359,235	188,640	14,338	817	348	563,378
Deposits from banks	5,712	5,578	299	-	-	11,589
Financial liabilities designated at fair value	3	10	31	1,021	410	1,475
Trading liabilities	48,282	-	-	-	-	48,282
Derivative financial instruments	14,376	37	(46)	248	52	14,667
Certificates of deposit and other debt securities in issue	-	337	1,154	1,443	-	2,934
Other financial liabilities	4,254	2,616	2,796	58	117	9,841
Subordinated liabilities	-	91	272	9,960	-	10,323
	<u>431,862</u>	<u>197,309</u>	<u>18,844</u>	<u>13,547</u>	<u>927</u>	<u>662,489</u>
Commitments	3,282	32,087	12,206	154,778	10	202,363
Financial guarantee contracts	358	752	1,377	914	374	3,775
	<u>3,640</u>	<u>32,839</u>	<u>13,583</u>	<u>155,692</u>	<u>384</u>	<u>206,138</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (b) Liquidity risk (continued)

	Bank					Total
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	
<b>At 31 December 2009</b>						
Current, savings and other deposit accounts	486,023	112,668	13,207	403	-	612,301
Deposits from banks	2,963	1,365	25	117	-	4,470
Financial liabilities designated at fair value	-	10	1,010	-	-	1,020
Trading liabilities	35,071	-	-	-	-	35,071
Derivative financial instruments	3,572	71	324	217	(8)	4,176
Certificates of deposit and other debt securities in issue	-	344	1,214	328	-	1,886
Amounts due to subsidiaries	4,749	4,973	238	-	-	9,960
Other financial liabilities	5,794	4,053	646	50	909	11,452
Subordinated liabilities	-	12	3,547	5,846	-	9,405
	<u>538,172</u>	<u>123,496</u>	<u>20,211</u>	<u>6,961</u>	<u>901</u>	<u>689,741</u>
Commitments	219	30,506	9,778	155,290	11	195,804
Financial guarantee contracts	599	741	754	255	372	2,721
	<u>818</u>	<u>31,247</u>	<u>10,532</u>	<u>155,545</u>	<u>383</u>	<u>198,525</u>
<b>At 31 December 2008</b>						
Current, savings and other deposit accounts	354,343	182,448	11,096	123	348	548,358
Deposits from banks	5,711	2,560	-	-	-	8,271
Financial liabilities designated at fair value	-	10	31	1,021	-	1,062
Trading liabilities	43,467	-	-	-	-	43,467
Derivative financial instruments	14,376	38	(48)	245	52	14,663
Certificates of deposit and other debt securities in issue	-	337	1,154	1,443	-	2,934
Amounts due to subsidiaries	3,532	5,044	-	-	-	8,576
Other financial liabilities	4,159	2,071	2,398	2	910	9,540
Subordinated liabilities	-	91	272	9,960	-	10,323
	<u>425,588</u>	<u>192,599</u>	<u>14,903</u>	<u>12,794</u>	<u>1,310</u>	<u>647,194</u>
Commitments	265	30,702	7,753	153,847	10	192,577
Financial guarantee contracts	358	753	1,377	912	374	3,774
	<u>623</u>	<u>31,455</u>	<u>9,130</u>	<u>154,759</u>	<u>384</u>	<u>196,351</u>

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (c) Market risk

Market risk is the risk that foreign exchange rates, interest rates, equity and commodity prices and indices will move and result in profits or losses for the Group. The objective of the Group's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the Group's status as a premier provider of financial products and services.

The Group separates exposures to market risk into either trading or non-trading portfolios. Trading portfolios include those positions arising from market-making, proprietary position-taking, strategic foreign exchange and other marked-to-market positions with trading intent. Non-trading portfolios primarily arise from the effective interest rate management of the Group's retail and commercial banking assets and liabilities.

The management of market risk is principally undertaken in Treasury using risk limits approved by the Risk Management Committee. Limits are set for each portfolio, product and risk type, with market liquidity being a principal factor in determining the level of limits set. The Group has dedicated standards, policies and procedures in place to control and monitor the market risk. An independent market risk control function is responsible for measuring market risk exposures, monitoring and reporting these exposures against the prescribed limits on a daily basis. The market risks which arise on each business are assessed and transferred to either Treasury for management, or to separate books managed under the supervision of ALCO.

#### Value at risk ("VAR")

One of the principal tools used by the Group to monitor and limit market risk exposure is VAR. The Group has obtained approval from the HKMA to use its VAR model for calculation of market risk capital charge.

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. Historical simulation uses scenarios derived from historical market rates and takes account of the relationships between different markets and rates, for example, interest rates and foreign exchange rates. Movements in market prices are calculated by reference to market data from the last two years. The assumed holding period is a 1-day period with a 99 per cent level of confidence, reflecting the way the risk positions are managed.

VAR is calculated daily. The Group validates the accuracy of its VAR models by back-testing the actual daily profit and loss results which include both end of day market movements and intra-day trading outcomes, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the Group would expect to see losses in excess of VAR only one per cent of the time over a one-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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 per cent 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 its VAR limits with other position and sensitivity limit structures. Additionally, the Group applies a wide range of stress testing, both on individual portfolios and on the Group's consolidated positions. The Group's stress testing regime provides senior management with an assessment of the financial impact of identified extreme events on the market risk exposures of the Group.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (c) Market risk (continued)

The Group's VAR, both trading and non-trading, for all interest rate risk and foreign exchange risk positions and on individual risk portfolios during 2009 and 2008 are shown in the table below.

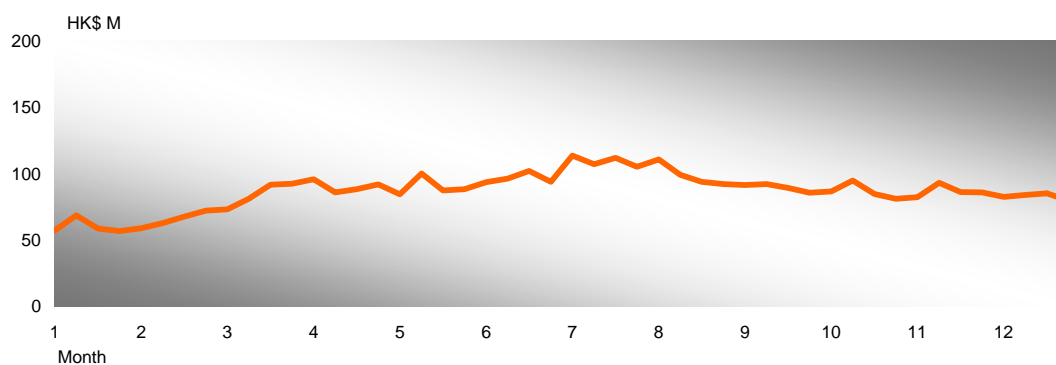
Value at risk

	At 31 December 2009	Minimum during the year	Maximum during the year	Average for the year
VAR for all interest rate risk and foreign exchange risk	76	46	130	86
VAR for foreign exchange risk (trading)	2	1	24	7
VAR for interest rate risk:				
- trading	7	5	13	8
- non-trading	73	47	115	83

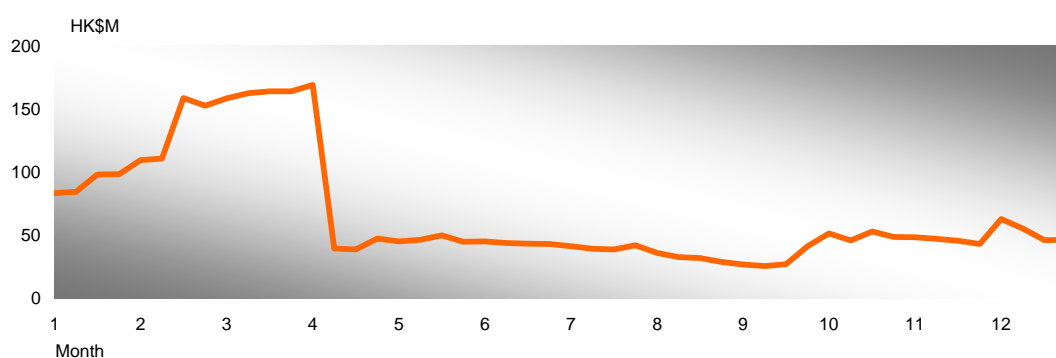
  

	At 31 December 2008	Minimum during the year	Maximum during the year	Average for the year
VAR for all interest rate risk and foreign exchange risk	46	24	169	65
VAR for foreign exchange risk (trading)	10	2	13	6
VAR for interest rate risk:				
- trading	8	1	12	4
- non-trading	46	24	163	63

#### VALUE AT RISK FOR 2009



#### VALUE AT RISK FOR 2008



**NOTES TO THE FINANCIAL STATEMENTS** (continued)

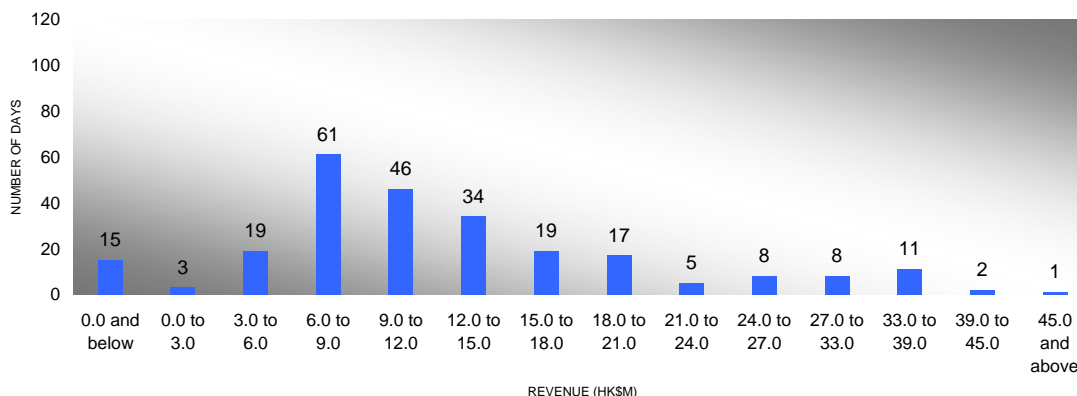
**62 Financial risk management** (continued)

**(c) Market risk** (continued)

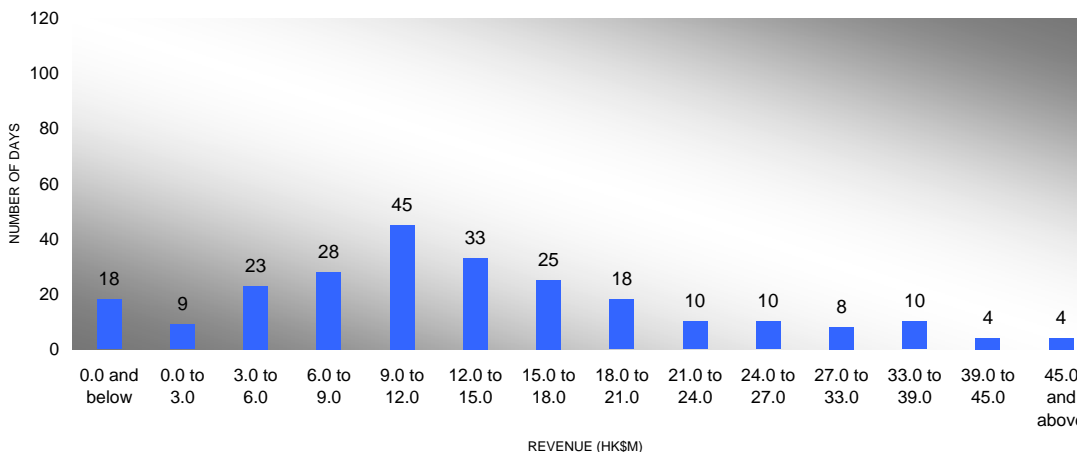
The average daily revenue earned from market risk-related treasury activities in 2009, including non-trading book net interest income and funding related to trading positions, was HK\$12 million (2008: HK\$14 million). The standard deviation of these daily revenues was HK\$10 million, compared with HK\$11 million for 2008.

An analysis of the frequency distribution of daily revenue shows that out of 249 trading days in 2009, losses were recorded on 15 days (2008: 18 days) and the maximum daily loss was HK\$24 million (2008: HK\$25 million). The most frequent result was a daily revenue of between HK\$3 million and HK\$15 million, with 160 occurrences (2008: 129 occurrences). The highest daily revenue was HK\$62 million (2008: HK\$52 million).

**DAILY DISTRIBUTION OF MARKET RISK REVENUES FOR 2009**



**DAILY DISTRIBUTION OF MARKET RISK REVENUES FOR 2008**



## NOTES TO THE FINANCIAL STATEMENTS (continued)

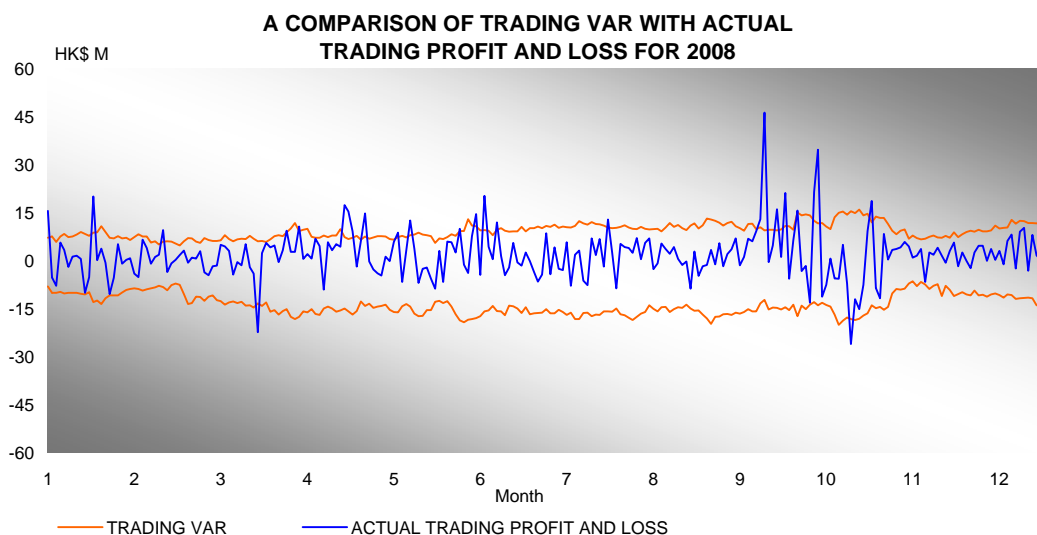
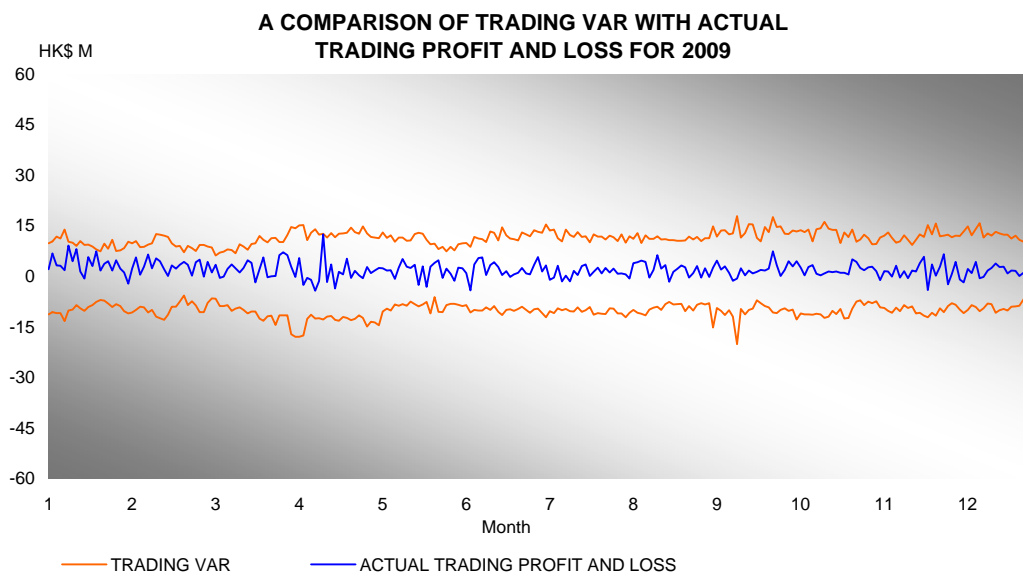
### 62 Financial Risk Management (continued)

#### (c) Market risk (continued)

Back-testing of the interest rate and foreign exchange model uses cleaned profits and losses from trading operations and compares these to overall, foreign exchange and interest rate level VAR on a daily basis.

The trading VAR model back-testing with actual profit and loss involves tracking the trading VAR with the next day actual profit and loss. It will be regarded as a loss side exception if actual loss exceeds loss side trading VAR.

A comparison of the Group trading VAR with the actual profits and losses related to trading positions during 2009 and 2008 are shown in the table below. The exceptions of the back-testing mainly resulted from unanticipated market movement.



## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial Risk Management *(continued)*

#### (c) Market risk *(continued)*

##### Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading and non-trading portfolios which include structural interest rate exposures. Treasury manages interest rate risks within the limits approved by the Risk Management Committee and under the monitoring of both ALCO and Risk Management Committee.

##### Trading

The Group's control of market risk is based on restricting individual operations to trading within VAR and underlying sensitivity limits including foreign exchange position limits, present value of a basis point ("PVBP") limits and option trading limits, and a list of permissible instruments authorised by the Risk Management Committee, and enforcing rigorous new product approval procedures. In particular, trading in the derivative products is supported by robust control systems whereas more complicated derivatives are mainly traded on back-to-back basis. Analysis of VAR for trading portfolio is disclosed in "Value at Risk" section.

##### Non-trading

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate 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. Structural interest rate risk arises from the differing repricing characteristics of commercial banking assets and liabilities, including non-interest bearing liabilities, such as shareholders' funds and some current accounts.

Analysis of these risks 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. The prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions, should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios and structural interest rate risks are transferred to Treasury or to separate books managed under the supervision of the ALCO.

The transfer of market risk to books managed by Treasury 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. ALCO regularly monitor all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits established by the Risk Management Committee.

##### Net interest income

A principal part of the Group's management of interest rate risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The Group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

The table below sets out the impact on future net interest income of a 100 basis points parallel fall or rise in all-in yield curves at the beginning of year from 1 January 2010 and 25 basis points parallel fall or rise in all-in yield curves at the beginning of each quarter during the 12 month period from 1 January 2010.

Assuming no management actions, such a series of incremental parallel rises in all-in yield curves would increase planned net interest income for the year to 31 December 2010 by HK\$2,186 million for 100 basis points case and by HK\$1,188 million for 25 basis points case, while such a series of incremental parallel falls in all-in yield curves would decrease planned net interest income by HK\$2,160 million for 100 basis points case and by HK\$1,254 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and takes into account the change in pricing of retail products relative to change in market interest rates.



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (c) Market risk (continued)

##### Projected Net Interest Income

The sensitivity of projected net interest income is described as follows:

	100bp parallel increase	100bp parallel decrease	25bp increase at the beginning of each quarter	25bp decrease at the beginning of each quarter
<b>Change in 2010 projected net interest income</b>				
- HKD	1,737	(1,949)	993	(1,426)
- USD	214	(95)	72	143
- other	235	(116)	123	29
Total	<u>2,186</u>	<u>(2,160)</u>	<u>1,188</u>	<u>(1,254)</u>
<b>Change in 2009 projected net interest income</b>				
- HKD	147	(1,012)	2	(677)
- USD	276	(58)	138	39
- other	110	(111)	30	(30)
Total	<u>533</u>	<u>(1,181)</u>	<u>170</u>	<u>(668)</u>

The interest rate sensitivities set out in the table above are illustrative only and are based on simplified scenarios. The figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Group's current interest rate risk profile. This effect, however, does not incorporate actions that would be taken by Treasury or in the business units to mitigate the impact of this interest rate risk. In reality, Treasury seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assume that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections also make other simplifying assumptions, including that all positions run to maturity.

It can be seen from the above that projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures. In a rising rate environment, the most critical exposures are those managed within Treasury.

##### Sensitivity of reserves

The Group monitors the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all-in yield curves. The table below describes the sensitivity to these movements at the end of the reporting period indicated below and the maximum and minimum month figures during the year then ended:

	At 31 December 2009	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(975)	(996)	(729)
As a percentage of shareholders' funds at 31 December 2009 (%)	(1.7)	(1.7)	(1.3)
- 100 basis points parallel move in all-in yield curves	975	996	729
As a percentage of shareholders' funds at 31 December 2009 (%)	1.7	1.7	1.3
	At 31 December 2008	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(725)	(1,053)	(725)
As a percentage of shareholders' funds at 31 December 2008 (%)	(1.4)	(2.0)	(1.4)
- 100 basis points parallel move in all-in yield curves	725	1,053	725
As a percentage of shareholders' funds at 31 December 2008 (%)	1.4	2.0	1.4

The sensitivities included in the table are illustrative only and are based on simplified scenarios. Moreover, the table shows only those interest rate risk exposures arising in available-for-sale portfolios and from cash flow hedges. These particular exposures form only a part of the Group's overall interest rate exposures.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (c) Market risk (continued)

##### Foreign exchange exposure

The Group's foreign exchange exposures mainly comprise foreign exchange dealing by Treasury and currency exposures originated by its banking business. The latter are transferred to Treasury where they are centrally managed within foreign exchange position limits approved by the Risk Management Committee. Net option position is calculated on the basis of delta-weighted positions of all foreign exchange options contract. Structural foreign exchange positions arising from capital investments in associate, subsidiaries and branches outside Hong Kong, mainly in US dollar and Chinese renminbi as set out below, are managed by ALCO.

The tables below summarise the net structural and non-structural foreign currency positions of the Group and the Bank.

	Group			
	USD	RMB	Other foreign currencies	Total foreign currencies
<b>2009</b>				
<b>Non-structural position</b>				
Spot assets	214,379	41,638	143,592	399,609
Spot liabilities	(164,511)	(41,564)	(110,044)	(316,119)
Forward purchases	169,349	29,483	42,340	241,172
Forward sales	(219,453)	(29,603)	(76,020)	(325,076)
Net options position	(4)	-	7	3
Net short non-structural position	<u>(240)</u>	<u>(46)</u>	<u>(125)</u>	<u>(411)</u>
<b>Structural position</b>	<u>285</u>	<u>14,550</u>	<u>287</u>	<u>15,122</u>
<b>2008</b>				
<b>Non-structural position</b>				
Spot assets	240,624	37,665	154,872	433,161
Spot liabilities	(200,971)	(37,568)	(89,134)	(327,673)
Forward purchases	269,935	26,549	44,434	340,918
Forward sales	(303,047)	(27,082)	(110,258)	(440,387)
Net options position	(1)	-	2	1
Net long/(short) non-structural position	<u>6,540</u>	<u>(436)</u>	<u>(84)</u>	<u>6,020</u>
<b>Structural position</b>	<u>285</u>	<u>13,343</u>	<u>202</u>	<u>13,830</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (c) Market risk (continued)

##### Foreign exchange exposure (continued)

	Bank			Total foreign currencies
	USD	RMB	Other foreign currencies	
<b>2009</b>				
<b>Non-structural position</b>				
Spot assets	178,264	13,820	105,554	297,638
Spot liabilities	(130,310)	(12,730)	(71,643)	(214,683)
Forward purchases	165,452	27,274	41,750	234,476
Forward sales	(215,240)	(27,146)	(75,789)	(318,175)
Net options position	(4)	-	7	3
Net (short)/long non-structural position	<u>(1,838)</u>	<u>1,218</u>	<u>(121)</u>	<u>(741)</u>
<b>Structural position</b>	<u>285</u>	<u>14,550</u>	<u>287</u>	<u>15,122</u>
<b>2008</b>				
<b>Non-structural position</b>				
Spot assets	202,503	13,718	125,155	341,376
Spot liabilities	(164,750)	(12,320)	(59,144)	(236,214)
Forward purchases	266,721	23,991	43,605	334,317
Forward sales	(300,209)	(23,931)	(109,700)	(433,840)
Net options position	(1)	-	2	1
Net long/(short) non-structural position	<u>4,264</u>	<u>1,458</u>	<u>(82)</u>	<u>5,640</u>
<b>Structural position</b>	<u>285</u>	<u>13,343</u>	<u>202</u>	<u>13,830</u>

##### Equities exposure

The Group's equities exposures in 2009 and 2008 are mainly in long-term equity investments which are reported as "Financial investments" set out in note 36. Equities held for trading purpose are included under "Trading assets" set out in note 32. These are subject to trading limit and risk management control procedures and other market risk regime.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (d) Insurance risk

##### **Risk management objectives and policies for management of insurance risk**

Through its insurance subsidiaries, the Group offers comprehensive insurance products, including life and non-life insurance, to both personal and commercial customers. These insurance operating subsidiaries are subject to the supervision of the Office of the Commissioner of Insurance ("OCI") and are required to observe the relevant compliance requirements stipulated by the Insurance Commissioner.

The Group is exposed to the uncertainty surrounding the timing and severity of insurance claims under its insurance contracts. The Group also has exposure to market risk through its insurance and investment contracts.

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

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.

##### **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 Market and Liquidity Risk Committee of the Group's insurance subsidiaries review and approve 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 according to 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.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

The following table shows the composition of assets and liabilities for each major insurance product category.

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

	Life linked contracts <sup>1</sup>	Life non-linked contracts <sup>2</sup>	Non-life insurance <sup>3</sup>	Other assets <sup>4</sup>	Total
<b>2009</b>					
Financial assets:					
- financial assets designated at fair value	217	4,441	-	616	5,274
- derivatives	-	78	-	-	78
- financial investments	-	46,791	-	2,329	49,120
- other financial assets	130	2,340	474	777	3,721
Total financial assets	347	53,650	474	3,722	58,193
Reinsurance assets	-	17	81	23	121
PVIF <sup>5</sup>	-	-	-	3,466	3,466
Other assets	-	607	7	713	1,327
Total assets	347	54,274	562	7,924	63,107
Liabilities under investment contracts					
designated at fair value	121	332	-	-	453
Liabilities under insurance contracts	224	53,588	428	-	54,240
Deferred tax	-	-	-	533	533
Other liabilities	-	-	-	225	225
Total liabilities	345	53,920	428	758	55,451
Shareholders' equity	-	-	-	7,656	7,656
Total liabilities and shareholders' equity	345	53,920	428	8,414	63,107
<b>2008</b>					
Financial assets:					
- financial assets designated at fair value	144	6,064	-	757	6,965
- derivatives	-	-	-	-	-
- financial investments	-	34,646	-	1,829	36,475
- other financial assets	136	2,448	491	734	3,809
Total financial assets	280	43,158	491	3,320	47,249
Reinsurance assets	-	16	49	22	87
PVIF <sup>5</sup>	-	-	-	2,707	2,707
Other assets	-	468	8	404	880
Total assets	280	43,642	548	6,453	50,923
Liabilities under investment contracts					
designated at fair value	85	328	-	-	413
Liabilities under insurance contracts	191	43,214	430	-	43,835
Deferred tax	-	-	-	375	375
Other liabilities	-	-	-	313	313
Total liabilities	276	43,542	430	688	44,936
Shareholders' equity	-	-	-	5,987	5,987
Total liabilities and shareholders' equity	276	43,542	430	6,675	50,923

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

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (d) Insurance risk *(continued)*

##### ***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 uses 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.

##### ***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 are usually provided. Discretionary participating features allow policyholders to participate in the profits of the life fund by means of annual bonus. 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 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.

##### (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 guarantees for some specific funds. The guarantee risks are managed through investment in good quality fixed rate bonds. Investment strategy is set with the objective of providing 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 must manage the scheme members' exposure to market risk in a manner consistent with any parameters set out in the policy documents.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

##### (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 risks 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.

#### **Concentration 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, conflagrations, 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 insured 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.

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 the above.

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 are 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. Details of the analysis of life insurance liabilities are disclosed in note 49. 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**

	2009	2008
Accident and health	108	115
Fire and other damage	110	117
Motor	23	27
Liability	58	43
Marine, aviation and transport	19	24
Other (non-life)	11	5
	<u>329</u>	<u>331</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

##### Financial risks

The Group's insurance businesses are exposed to a range of financial risks, including 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 2009 by type of liability, and provides a view of the exposure to financial risk:

##### Financial assets held by insurance operations

	Group				Total
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	
<b>2009</b>					
Financial assets designated at fair value:					
- debt securities	-	4,136	-	616	4,752
- equity securities	217	305	-	-	522
	<u>217</u>	<u>4,441</u>	<u>-</u>	<u>616</u>	<u>5,274</u>
Financial investments					
Held-to-maturity:					
- debt securities	-	46,791	-	1,878	48,669
	<u>-</u>	<u>46,791</u>	<u>-</u>	<u>1,878</u>	<u>48,669</u>
Available-for-sale:					
- debt securities	-	-	-	445	445
- equity securities	-	-	-	6	6
	<u>-</u>	<u>-</u>	<u>-</u>	<u>451</u>	<u>451</u>
Derivatives	-	78	-	-	78
Other financial assets	130	2,340	474	777	3,721
	<u>347</u>	<u>53,650</u>	<u>474</u>	<u>3,722</u>	<u>58,193</u>



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

	Group				Total
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	
2008					
Financial assets designated at fair value:					
- debt securities	-	5,847	-	757	6,604
- equity securities	144	217	-	-	361
	<u>144</u>	<u>6,064</u>	<u>-</u>	<u>757</u>	<u>6,965</u>
Financial investments					
Held-to-maturity:					
- debt securities	-	34,646	-	1,559	36,205
	<u>-</u>	<u>34,646</u>	<u>-</u>	<u>1,559</u>	<u>36,205</u>
Available-for-sale:					
- debt securities	-	-	-	266	266
- equity securities	-	-	-	4	4
	<u>-</u>	<u>-</u>	<u>-</u>	<u>270</u>	<u>270</u>
Derivatives	-	-	-	-	-
Other financial assets	136	2,448	491	734	3,809
	<u>280</u>	<u>43,158</u>	<u>491</u>	<u>3,320</u>	<u>47,249</u>

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 0.6% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2009 (2008: 0.6%). The table also shows that approximately 92.6% of financial assets was invested in debt securities at 31 December 2009 (2008: 91.2%) with 0.9% (2008: 0.8%) invested in equity securities.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

##### **Market risk**

Market risk can be described as the risk of change in fair value of a financial instrument due to change in interest rate, equity prices and foreign currency rates. Each of these categories is discussed further below.

##### Interest rate risk

The insurance subsidiaries of 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 which 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 feature.

An immediate and permanent movement in interest yield curves as at 31 December 2009 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:

	2009		2008	
	Impact on profit for the year	Impact on net assets	Impact on profit for the year	Impact on net assets
+ 100 basis points shift in yield curves	205	197	210	208
- 100 basis points shift in yield curves	(128)	(120)	(139)	(136)

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.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (d) Insurance risk *(continued)*

##### Equity risk

The portfolio of marketable equity securities, which the insurance subsidiaries of the Group carries on the statement of financial position 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:

	2009		2008	
	Impact on profit for the year	Impact on net assets	Impact on profit for the year	Impact on net assets
10 per cent increase in equity prices	26	26	18	18
10 per cent decrease in equity prices	(26)	(26)	(18)	(18)

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.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

Credit risk

The insurance subsidiaries of 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 treasury bills, other eligible bills and debt securities within the Group's insurance operations.

#### Treasury bills, other eligible bills and debt securities in insurance operations

	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub- standard				
<b>2009</b>							
<b>Supporting liabilities under non-linked insurance and investment contracts</b>							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	4,051	85	-	-	-	-	4,136
	<u>4,051</u>	<u>85</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,136</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	46,239	552	-	-	-	-	46,791
	<u>46,239</u>	<u>552</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>46,791</u>
<b>Supporting shareholders funds</b>							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	616	-	-	-	-	-	616
	<u>616</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>616</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	2,323	-	-	-	-	-	2,323
	<u>2,323</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>2,323</u>
<b>Total</b>							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	4,667	85	-	-	-	-	4,752
	<u>4,667</u>	<u>85</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,752</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	48,562	552	-	-	-	-	49,114
	<u>48,562</u>	<u>552</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>49,114</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub- standard				
2008							
<b>Supporting liabilities under non-linked insurance and investment contracts</b>							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	5,605	242	-	-	-	-	5,847
	<u>5,605</u>	<u>242</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>5,847</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	34,604	42	-	-	-	-	34,646
	<u>34,604</u>	<u>42</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>34,646</u>
<b>Supporting shareholders funds</b>							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	757	-	-	-	-	-	757
	<u>757</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>757</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	1,824	1	-	-	-	-	1,825
	<u>1,824</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,825</u>
<b>Total</b>							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	6,362	242	-	-	-	-	6,604
	<u>6,362</u>	<u>242</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>6,604</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	36,428	43	-	-	-	-	36,471
	<u>36,428</u>	<u>43</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>36,471</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (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

	<u>Neither past due nor impaired</u>			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub- standard				
<b>2009</b>							
Linked insurance contracts	-	-	-	-	-	-	-
Non-linked insurance contracts	<u>82</u>	<u>16</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>98</u>
Total	<u>82</u>	<u>16</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>98</u>
Reinsurance Debtors	<u>7</u>	<u>2</u>	<u>-</u>	<u>13</u>	<u>-</u>	<u>-</u>	<u>22</u>
<b>2008</b>							
Linked insurance contracts	-	-	-	-	-	-	-
Non-linked insurance contracts	<u>63</u>	<u>2</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>65</u>
Total	<u>63</u>	<u>2</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>65</u>
Reinsurance Debtors	<u>8</u>	<u>1</u>	<u>-</u>	<u>12</u>	<u>-</u>	<u>-</u>	<u>21</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

##### 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.

The following table shows the expected maturity of insurance contract liabilities at 31 December 2009 and 31 December 2008:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				Total
	Within 1 year	Over 1 year but within 5 years	Over 5 years but within 15 years	Over 15 years	
<b>2009</b>					
Non-life insurance	249	160	33	-	442
Life insurance (non-linked)	3,985	26,231	56,760	32,549	119,525
Life insurance (linked)	28	183	158	973	1,342
	<u>4,262</u>	<u>26,574</u>	<u>56,951</u>	<u>33,522</u>	<u>121,309</u>

##### 2008

Non-life insurance	258	147	25	-	430
Life insurance (non-linked)	3,352	21,382	52,519	26,818	104,071
Life insurance (linked)	27	234	332	1,059	1,652
	<u>3,637</u>	<u>21,763</u>	<u>52,876</u>	<u>27,877</u>	<u>106,153</u>

Remaining contractual maturity of investment contract liabilities

	Liabilities under investment contracts by insurance underwriting subsidiaries			Total
	Linked investment contracts	Non-linked investment contracts	Investment contracts with DPF	
<b>2009</b>				
Remaining contractual maturity:				
- due within 1 year	2	-	-	2
- due over 1 year but within 5 years	-	-	-	-
- due over 5 years but within 10 years	-	-	-	-
- due over 10 years	-	-	-	-
- undated	119	332	-	451
	<u>121</u>	<u>332</u>	<u>-</u>	<u>453</u>
<b>2008</b>				
Remaining contractual maturity:				
- due within 1 year	2	1	-	3
- due over 1 year but within 5 years	-	-	-	-
- due over 5 years but within 10 years	-	-	-	-
- due over 10 years	83	327	-	410
- undated	-	-	-	-
	<u>85</u>	<u>328</u>	<u>-</u>	<u>413</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

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

The Group's life insurance business is accounted for using the embedded value approach, which, inter alia, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2009 was HK\$3,466 million (2008: HK\$2,707 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2009 can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF as at 31 December 2009 of reasonably possible changes in the main economic and business assumptions:

	2009	2008
+ 100 basis points shift in risk-free rate	548	504
- 100 basis points shift in risk-free rate	(375)	(331)
+ 100 basis points shift in risk discount rate	(181)	(153)
- 100 basis points shift in risk discount rate	204	172
+ 100 basis points shift in expenses inflation	(15)	(12)
- 100 basis points shift in expenses inflation	13	11
+ 100 basis points shift in lapse rate	853	793
- 100 basis points shift in lapse rate	(817)	(771)

The effects on PVIF shown above are illustrative only and employ simplified scenarios. The effects are calculated with taking into account the sharing of investment returns with policyholders through the discretionary participation feature. Other than that, they do not incorporate other actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

##### Non-economic assumptions

The sensitivity of profit for the year and net assets to reasonably possible changes in assumptions used in respect of insurance businesses at 31 December 2009 is as follows:

	Impact on 2009 results		Impact on 2008 results	
	Profit for the year	Net assets	Profit for the year	Net assets
20 per cent increase in claims costs	(24)	(24)	(26)	(26)
20 per cent decrease in claims costs	24	24	26	26
10 per cent increase in mortality and/or morbidity rates	(22)	(22)	(25)	(25)
10 per cent decrease in mortality and/or morbidity rates	21	21	26	26
50 per cent increase in lapse rates	535	535	505	505
50 per cent decrease in lapse rates	(549)	(549)	(516)	(516)
10 per cent increase in expense rates	(36)	(36)	(33)	(33)
10 per cent decrease in expense rates	36	36	33	33



## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (e) Operational risk

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

The Group manages its operational risk through a controls-based environment in which the processes and controls are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by periodic independent review of the internal control systems 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 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 Group's 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.

Operational risk is mitigated by adequate insurance coverage on assets and business losses. To reduce the impact and interruptions to business activities caused by system failure or natural disaster, back-up systems and contingency business resumption plans are in place for all business and critical operations functions. Operational risk management is coordinated by the Chief Technology and Services Officer and monitored by the Operational Risk Management Committee.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (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 Group capital plan is prepared and approved by the Board with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The Group 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, subsidiary with capital generated in excess of planned requirement will return to the Bank, normally by way of dividends. The Group also raised its subordinated debt in accordance with HSBC Group's guidelines regarding market and investor concentration, cost, market conditions, timing and maturity profile.

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 statement of financial position: called up share capital, retained profits, other reserves and subordinated liabilities. Capital also includes the collective impairment allowances held in respect of loans and advances and the regulatory reserve.

Externally imposed capital requirements:

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

The Basel Committee on Banking Supervision has published a new capital adequacy framework, known as "Basel II", for calculating minimum capital requirements. With effect from 1 January 2007, the Hong Kong Monetary Authority adopted Basel II as set out in the Banking (Capital) Rules made under the Banking Ordinances. The new Rules, which replace the Third Schedule to the Banking Ordinance, stipulate the calculation methodology for capital adequacy ratio. Basel II is structured around three "pillars": minimum capital requirements, supervisory review process and market discipline. The supervisory objectives for Basel II are to promote safety and soundness in the financial system and maintain at least the current overall level of capital in the system; enhance competitive equality; constitute a more comprehensive approach to addressing risks; and focus on internationally active bank.

With respect to Pillar One minimum capital requirements, Basel II provides three approaches, of increasing sophistication, to the calculation of credit risk regulatory capital. The most basic, the standardised approach, requires banks to use external credit ratings to determine risk weightings applied to rated counterparties, and groups other counterparties into broad categories and applies standardised risk weightings to these categories. In the next level, the foundation internal ratings-based approach, allows banks to calculate their credit risk regulatory capital requirement on the basis of their internal assessment of the probability that a counterparty will default ("PD"), but with quantification of exposure at default ("EAD") and loss given default estimates ("LGD") being subject to standard supervisory parameters. Finally, the advanced internal ratings-based approach, will allow banks to use their own internal assessment of not only the probability of default but also the quantification of exposure at default and loss given default.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 62 Financial risk management *(continued)*

#### (f) Capital management *(continued)*

Expected losses are calculated by multiplying EAD by PD and LGD. The capital resources requirement under the IRB approaches is intended to cover unexpected losses and is derived from a formula specified in the regulatory rules, which incorporates these factors and other variables such as maturity and correlation.

For credit risk, with the HKMA approval, the Group has adopted the advanced internal ratings-based approach for the majority of its business with effect from 1 January 2009, with the remainder on standardised approach.

Basel II also introduces capital requirements for operational risk and, again, contains three levels of sophistication. The capital required under the basic indicator approach is a simple percentage of gross revenues, whereas under the standardised approach it is one of three different percentage of gross revenues allocated to each of eight defined business lines. Finally, the advanced measurement approach uses bank's own statistical analysis and modelling of operational risk data to determine capital requirements. The Group has adopted the standardised approach to the determination of operational risk capital requirements.

For market risk, the Group is required to use a variety of approaches to calculate its market risk capital requirement, including the internal model approach and the standardised approach for different risk categories.

Under Pillar Two, the Group has initiated its internal capital adequacy assessment process ("ICAAP") to comply with HKMA's requirement set out in the Supervisory Policy Manual "Supervisory Review Process". The Group will also align with HSBC Group guidance in setting up its ICAAP.

To comply with Pillar Three requirements which focuses on disclosure requirements and policies as prescribed by the Banking (Disclosure) Rules, the Group has formulated a disclosure policy which was approved by the Board with an aim of making relevant disclosures in accordance with the disclosure rules.

During the year, the Group has complied with all of the externally imposed capital requirements by the Hong Kong Monetary Authority.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 63 Fair value of financial instruments

#### (a) Determination of fair value

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, derivatives, and financial investments 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. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of (i) valuation models; (ii) any inputs to those models; and (iii) any adjustments required outside of the valuation model, and, where possible, independent validation of model outputs. For fair values determined without a valuation model, independent price determination or validation is utilised.

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

Fair value are determined according to the following hierarchy:

(i) Level 1: Quoted market price

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

(ii) Level 2: Valuation technique using observable inputs

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

(iii) Level 3: 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 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.

To assist in understanding the extent of this uncertainty, additional information is provided in respect of these instruments in the 'Effect of changes in significant non-observable assumptions to reasonably possible alternatives' section below.

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 63 Fair value of financial instruments *(continued)*

#### (a) Determination of fair value *(continued)*

In certain circumstances, the Group applies the fair value option to its 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 unavailable, 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 Group reverse over the contractual life of the debt, provided that the debt is not repaid early.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the Group issues structured notes. These market spreads are significantly smaller than credit spreads observed for plain vanilla debt or in the credit default swap markets.

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

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 believes that there are additional considerations not included within the valuation model, appropriate adjustments may be made. Examples of such adjustments are:

- Credit risk adjustment: an adjustment to reflect the credit worthiness of over-the-counter ("OTC") derivative counterparties.

- 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 any unamortised balance is included as part of the fair value.

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

- 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 derived from observable market data, and, where relevant, assumptions in respect of unobservable inputs.

- 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 discrepancies 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 historical data or other sources.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 63 Fair value of financial instruments (continued)

#### (a) Determination of fair value (continued)

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 because of uncertainties inherent in estimating fair value for private equity investments.

#### Analysis of fair value determination

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

	Valuation techniques			Third party total	Amounts with HSBC entities	Total
	quoted market price	using observable inputs	with significant non-observable inputs			
<b>2009</b>						
<b>Assets</b>						
Trading assets	64,476	2,121	-	66,597	-	66,597
Financial assets designated at fair value	216	1,192	696	2,104	3,346	5,450
Derivative financial instruments	511	4,156	-	4,667	383	5,050
Available-for-sale financial investments	59,809	132,490	448	192,747	86	192,833
<b>Liabilities</b>						
Trading liabilities	12,932	24,703	756	38,391	-	38,391
Financial liabilities designated at fair value	-	1,456	-	1,456	-	1,456
Derivative financial instruments	92	2,845	-	2,937	1,314	4,251
<b>2008</b>						
<b>Assets</b>						
Trading assets	3,369	105,020	-	108,389	-	108,389
Financial assets designated at fair value	782	3,254	217	4,253	3,545	7,798
Derivative financial instruments	449	6,020	-	6,469	635	7,104
Available-for-sale financial investments	2,796	141,953	137	144,886	68	144,954
<b>Liabilities</b>						
Trading liabilities	3,563	42,381	2,338	48,282	-	48,282
Financial liabilities designated at fair value	-	1,407	-	1,407	-	1,407
Derivative financial instruments	35	7,485	-	7,520	7,425	14,945

**NOTES TO THE FINANCIAL STATEMENTS** (continued)

**63 Fair value of financial instruments** (continued)

**(a) Determination of fair value** (continued)

	Valuation techniques			Bank	Amounts with HSBC entities	Total
	quoted market price	using observable inputs	with significant non-observable inputs	Third party total		
<b>2009</b>						
<b>Assets</b>						
Trading assets	64,476	812	-	65,288	-	65,288
Financial assets						
designated at fair value	-	174	-	174	-	174
Derivative financial instruments	510	4,115	-	4,625	291	4,916
Available-for-sale financial investments	55,360	101,236	33	156,629	86	156,715
<b>Liabilities</b>						
Trading liabilities	12,932	21,537	602	35,071	-	35,071
Financial liabilities						
designated at fair value	-	1,003	-	1,003	-	1,003
Derivative financial instruments	92	2,765	-	2,857	1,323	4,180
<b>2008</b>						
<b>Assets</b>						
Trading assets	3,369	104,406	-	107,775	-	107,775
Financial assets						
designated at fair value	306	524	-	830	-	830
Derivative financial instruments	447	5,776	-	6,223	687	6,910
Available-for-sale financial investments	2,762	109,136	34	111,932	68	112,000
<b>Liabilities</b>						
Trading liabilities	3,563	37,566	2,338	43,467	-	43,467
Financial liabilities						
designated at fair value	-	994	-	994	-	994
Derivative financial instruments	33	7,417	-	7,450	7,488	14,938

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 63 Fair value of financial instruments (continued)

#### (a) Determination of fair value (continued)

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

	Group						
	Assets				Liabilities		
	Available - for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2009	137	-	217	-	2,338	-	-
Total gains or losses recognised in profit and loss	(3)	-	14	-	310	-	-
Total gains or losses recognised in other comprehensive income	1	-	-	-	-	-	-
Purchases	1	-	56	-	-	-	-
Issues	-	-	-	-	951	-	-
Sales	(5)	-	(9)	-	-	-	-
Settlements	-	-	-	-	(1,629)	-	-
Transfers out	-	-	-	-	(1,211)	-	-
Transfers in	317	-	418	-	-	-	-
Exchange adjustments	-	-	-	-	(3)	-	-
At 31 December 2009	<u>448</u>	<u>-</u>	<u>696</u>	<u>-</u>	<u>756</u>	<u>-</u>	<u>-</u>
Total gain or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	10	-	14	-	326	-	-



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 63 Fair value of financial instruments (continued)

#### (a) Determination of fair value (continued)

	Bank							
	Assets				Liabilities			
	Available - for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives	
At 1 January 2009	34	-	-	-	2,338	-	-	-
Total gains or losses recognised in profit and loss	-	-	-	-	309	-	-	-
Total gains or losses recognised in other comprehensive income	(1)	-	-	-	-	-	-	-
Purchases	-	-	-	-	-	-	-	-
Issues	-	-	-	-	798	-	-	-
Sales	-	-	-	-	-	-	-	-
Settlements	-	-	-	-	(1,629)	-	-	-
Transfers out	-	-	-	-	(1,211)	-	-	-
Transfers in	-	-	-	-	-	-	-	-
Exchange adjustments	-	-	-	-	(3)	-	-	-
At 31 December 2009	<u>33</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>602</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total gain or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	5	-	-	-	325	-	-	-

For available-for-sale securities and financial assets designated at fair value, the transfers into level 3 were due to valuations of certain debt securities becoming unobservable during the year.

For held-for-trading liabilities, transfers out of level 3 were primarily due to an increase in the observability of equity correlation.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under "Trading income".

The income statement line item "Net income/(expense) from financial instruments designated at fair value" captures fair value movements on all other financial instruments designated at fair value and related derivatives (including long-term subordinated notes issued).

Realised gains and losses from available-for-sale securities are presented under "Gains less losses from financial investments and fixed assets" in the income statement while unrealised gains and losses are presented in "Fair value changes taken to/(from) equity" within "Available-for-sale investment reserve" in other comprehensive income.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 63 Fair value of financial instruments (continued)

#### (a) Determination of fair value (continued)

*Effects of changes in significant non-observable assumptions to reasonably possible alternatives*

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values due to parallel movement of plus or minus 10 per cent of change in fair value to reasonably possible alternative assumptions.

	Group			
	<u>Reflected in profit/(loss)</u>		<u>Reflected in equity</u>	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
<b>2009</b>				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	<b>70</b>	<b>(70)</b>	-	-
Available-for-sale financial investments	-	-	<b>45</b>	<b>(45)</b>
<b>2008</b>				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	22	(22)	-	-
Available-for-sale financial investments	-	-	14	(14)

	Bank			
	<u>Reflected in profit/(loss)</u>		<u>Reflected in equity</u>	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
<b>2009</b>				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	-	-	-	-
Available-for-sale financial investments	-	-	<b>3</b>	<b>(3)</b>
<b>2008</b>				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	-	-	-	-
Available-for-sale financial investments	-	-	3	(3)

*Changes in fair value recorded in the income statement*

The following table details changes in fair values recognised in profit or loss during the year, 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.

	Group		Bank	
	2009	2008	2009	2008
Recorded profit/(loss):				
Derivatives/trading assets/trading liabilities	<b>310</b>	24	<b>309</b>	24
Financial assets/liabilities designated at fair value	<b>14</b>	(42)	-	-

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 63 Fair value of financial instruments *(continued)*

#### (a) Determination of fair value *(continued)*

##### *Fair value of financial instruments not carried at fair value*

The fair values of financial instruments that are not recognised at fair value on the statement of financial position 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 date of statement of financial position of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

#### (i) Loans and advances to customers

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

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

#### (ii) 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 earnings streams of, equivalent quoted securities.

#### (iii) Deposits and customer accounts

The fair value of deposits and customers account 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 date of statement of financial position.

#### (iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the date of statement of financial position where available, or by reference to quoted market prices for similar instruments.

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

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 financial instruments whose carrying amount is a reasonable approximation of fair value because, for example, they are short-term in nature or reprice to current market rates frequently:

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 63 Fair value of financial instruments (continued)

#### (a) Determination of fair value (continued)

##### Assets

Cash and balances at central banks  
 Items in the course of collection from other banks  
 Endorsements and acceptances  
 Short-term receivables within "Other assets"  
 Accrued income

##### Liabilities

Items in the course of transmission to other banks  
 Endorsements and acceptances  
 Short-term payables within "Other liabilities"  
 Accruals

The methods and significant assumptions applied in determining the fair value of financial instruments are set out in note 4(n).

#### (b) Fair value

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

	Group			
	2009		2008	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Financial Assets</b>				
Placings with and advances to banks and other financial institutions	104,551	104,551	69,579	69,635
Advances to customers	344,621	346,459	329,121	320,651
Held-to-maturity debt securities	48,669	49,805	36,205	39,315
<b>Financial Liabilities</b>				
Current, savings and other deposit accounts	636,369	636,435	562,183	562,257
Deposits from banks	4,870	4,870	11,556	11,556
Certificates of deposit and other debt securities in issue	1,826	1,859	2,772	2,838
Subordinated liabilities	9,320	9,041	9,309	7,849
<b>Bank</b>				
	2009		2008	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Financial Assets</b>				
Placings with and advances to banks and other financial institutions	65,624	65,624	38,097	38,154
Advances to customers	299,179	301,054	280,255	271,787
<b>Financial Liabilities</b>				
Current, savings and other deposit accounts	612,014	612,080	547,385	547,459
Deposits from banks	4,469	4,469	8,263	8,263
Certificates of deposit and other debt securities in issue	1,826	1,859	2,772	2,838
Subordinated liabilities	9,320	9,041	9,309	7,849

## NOTES TO THE FINANCIAL STATEMENTS *(continued)*

### 64 Comparative figures

As a result of the application of HKAS 1 (revised 2007), *Presentation of financial statements*, certain comparative figures have been adjusted to conform with the current year's presentation and to provide comparative amounts in respect of items disclosed for the first time in 2009. Further details of these developments are disclosed in note 5.

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### 65 Immediate and ultimate holding companies

The immediate and ultimate holding companies of the Bank are The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong) and HSBC Holdings plc (incorporated in England) respectively.

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### 66 Approval of financial statements

The financial statements were approved and authorised for issue by the Board of Directors on 1 March 2010.

## **Independent auditor's report to the shareholders of Hang Seng Bank Limited**

*(Incorporated in Hong Kong with limited liability)*

We have audited the consolidated financial statements of Hang Seng Bank Limited ("the Bank") set out on pages 76 to 227, which comprise the consolidated and the Bank statements of financial position as at 31 December 2009, and the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory 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 misstatement, 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 policies 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 affairs of the Bank and of the Group as at 31 December 2009 and of the Group's profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

## **KPMG**

Certified Public Accountants

8th Floor, Prince's Building  
10 Chater Road  
Central, Hong Kong

1 March 2010

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited)*

These notes set out on pages 229 to 251 are supplementary to and should be read in conjunction with the consolidated financial statements set out on pages 76 to 227. The consolidated financial statements and these supplementary notes taken together comply with the Banking (Disclosure) Rules (the "Disclosure Rules") made under section 60A of the Banking Ordinance.

### 1 Basis of preparation

- (a) Except where indicated otherwise, the financial information contained in these supplementary notes has been prepared on a consolidated basis in accordance with Hong Kong Financial Reporting Standards. Some parts of these supplementary notes, however, are required by the Disclosure Rules to be prepared on a different basis. In such cases, the Disclosure Rules require that certain information is prepared on a basis which excluded some of the subsidiaries of the Bank.

Further information regarding subsidiaries that are not included in the consolidation for regulatory purpose is set out in note 2 to the supplementary notes to the financial statements.

- (b) The accounting policies applied in preparing these supplementary notes are the same as those applied in preparing the consolidated financial statements for the year ended 31 December 2009 as set out in note 4 to the financial statements.

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### 2 Capital adequacy

#### (a) Capital adequacy ratios

The capital adequacy ratios as at 31 December 2009 are computed on the consolidated basis of the Bank and certain of its subsidiaries as specified by the HKMA for its regulatory purposes, and are in accordance with the Banking (Capital) Rules ("the Capital Rules") of the Hong Kong Banking Ordinance which became effective on 1 January 2007.

Under the Capital Rules with effective from 1 January 2007, the Group used the standardised (credit risk) approach to calculate its credit risk for non-securitisation exposures. With effective from 1 January 2008, the Group adopted the foundation internal ratings-based approach to determine credit risk. It also used the standardised (operational risk) approach to calculate its operational risk. For market risk, an internal model approach is adopted for calculating general market risk, while standardised (market risk) approach is adopted for calculating specific interest rate risk and equity risk.

From 1 January 2009, the Group has migrated to the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. As a result, the numbers for 2009 and 2008 are not directly comparable. Apart from these, there are no changes in the approaches used to calculate operational risk and market risk for other risk categories. In addition, there is no relevant capital shortfall in any of the Group's subsidiaries which are not included in its consolidation group for regulatory purposes.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 2 Capital adequacy (continued)

#### (a) Capital adequacy ratios (continued)

The capital base after deductions used in the calculation of capital adequacy ratios as at 31 December and reported to HKMA is analysed as follows:

	2009	2008
<b>Capital base</b>		
Core capital:		
- share capital	9,559	9,559
- retained profits	31,708	24,290
- classified as regulatory reserve	(920)	(854)
- less: deduction from core capital	(561)	(557)
- less: 50 per cent of total unconsolidated investments and other deductions	(7,330)	(6,330)
- total core capital	<b>32,456</b>	26,108
Supplementary capital:		
- fair value gains on the revaluation of property	3,732	3,465
- fair value gains on the revaluation of available-for-sale investment and equity	498	649
- collectively assessed impairment allowances	81	78
- regulatory reserve	101	94
- surplus provision	-	101
- term subordinated debt	10,354	10,357
- less: 50 per cent of total unconsolidated investments and other deductions	(7,330)	(6,330)
- total supplementary capital	<b>7,436</b>	8,414
Total capital base after deductions	<b><u>39,892</u></b>	<u>34,522</u>
<b>Risk-weighted assets</b>		
- credit risk	212,434	235,576
- market risk	1,278	1,684
- operational risk	39,017	38,104
	<b><u>252,729</u></b>	<u>275,364</u>
Capital adequacy ratio	<b>15.8%</b>	12.5%
Core capital ratio	<b>12.8%</b>	9.5%

#### (b) Basis of consolidation

The basis of consolidation for calculation of capital ratios under the Capital Rules follows the basis of consolidation for financial reporting with the exclusion of subsidiaries which are "regulated financial entities" (e.g. insurance and securities companies) as defined by the Capital Rules. Accordingly, the investment costs of these unconsolidated regulated financial entities are deducted from the capital base. The unconsolidated regulated financial entities are:

Hang Seng Bank (Trustee) Limited  
 Hang Seng Bank Trustee International Limited  
 Hang Seng Futures Limited  
 Hang Seng General Insurance (Hong Kong) Company Limited  
 Hang Seng Insurance Company Limited  
 Hang Seng Insurance (Bahamas) Limited  
 Hang Seng Investment Management Limited  
 Hang Seng Investment Services Limited  
 Hang Seng Life Limited  
 Hang Seng (Nominee) Limited  
 Hang Seng Securities Limited

The Group operates subsidiaries in a number of countries and territories where capital will be governed by local rules and there may be restrictions on the transfer of regulatory capital and funds between members of the banking group.



## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 3 Credit risk capital requirements

In 2009, the Group used the advanced internal ratings-based ("IRB") approach to calculate its credit risk for the majority of its non-securitisation exposures. The remainder of its credit risk for non-securitisation exposures was assessed using the standardised (credit risk) approach. In 2008, the Group used the foundation IRB and the standardised (credit risk) approach.

The table below shows the capital requirements for credit risk for each class and subclass of exposures as specified in the Capital Rules.

	2009	2008
<b>Subject to internal ratings-based approach</b>		
Sovereign exposures	128	413
Bank exposures	2,270	4,005
Corporate exposures	9,943	9,477
Residential mortgages to individuals and property-holding shell companies	663	1,099
Qualifying revolving retail exposures	825	750
Small business retail exposure	8	12
Other retail exposures to individuals	340	316
Other exposures	969	915
Securitisation exposures	-	-
Equity exposures	-	-
<b>Total capital requirements for credit risk under internal ratings-based approach</b>	<b>15,146</b>	<b>16,987</b>
<b>Subject to standardised (credit risk) approach</b>		
<b>On-balance sheet</b>		
Sovereign exposures	-	-
Public sector entity exposures	89	43
Multilateral development bank exposures	-	-
Bank exposures	-	15
Securities firm exposures	-	-
Corporate exposures	312	397
Collective investment scheme exposures	4	6
Cash items	-	-
Regulatory retail exposures	152	142
Residential mortgage loans	701	586
Other exposures which are not past due exposures	399	467
Past due exposures	48	36
Total capital requirements for on-balance sheet exposures	<b>1,705</b>	<b>1,692</b>
<b>Off-balance sheet</b>		
Direct credit substitutes	36	35
Transaction-related contingencies	2	20
Trade-related contingencies	6	18
Forward asset purchases	3	5
Partly paid-up shares and securities	-	-
Forward deposits placed	-	-
Unconditionally cancellable commitments	-	-
Other commitments	82	54
Exchange rate contracts	11	22
Interest rate contracts	-	1
Equity contracts	4	12
OTC derivative transactions and credit derivative contracts subject to valid bilateral netting agreements	-	-
Other off-balance exposures which are not elsewhere specified	-	-
Total capital requirements for off-balance sheet exposures	<b>144</b>	<b>167</b>
<b>Total capital requirements for credit risk under standardised (credit risk) approach</b>	<b>1,849</b>	<b>1,859</b>
<b>Total capital requirements for credit risk</b>	<b>16,995</b>	<b>18,846</b>

The capital requirement is made by multiplying the Group's risk-weighted amount derived from the relevant calculation approach by 8 per cent. It does not reflect the Group's actual regulatory capital.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited) (continued)*

### 4 Credit risk under the internal-ratings based approach

#### (a) The internal rating system

##### (i) Nature of exposures within each internal-ratings based ("IRB") class

The Group adopted advanced IRB approach for the majority of its business with effect from 1 January 2009, with the remainder on standardised approach. The following exposures are subject to IRB approach:

- Corporate exposures include exposures to global large corporates, local large corporates, middle market corporates and small and medium-sized enterprises, non-bank financial institutions and specialised lending.
- Sovereign exposures include exposures to sovereign governments, central monetary institutions and government entities.
- Bank exposures include exposures to banks and regulated securities firms.
- Retail exposures include residential mortgages, qualifying revolving retail exposures, small business retail exposures and other retail exposures.
- Other exposures mainly include notes and coins, premises, plant and equipment and other fixed assets.

##### (ii) Structure of rating systems and control mechanisms

The Group's exposure to credit risk arises from a wide range of asset classes, customers and product types. To measure and manage the risk in these exposures, both to individually assessed customers and to those aggregated into portfolios, the Group employs diverse risk rating systems and methodologies: judgmental, analytical, and hybrids of the two. The main characteristics of the Group's credit risk rating systems are set out below.

The Group-wide credit risk rating framework incorporates probability of default ("PD") of an obligor and loss severity expressed in terms of exposures at default ("EAD") and loss given default ("LGD"). These measures are used to calculate expected loss and capital requirements. They are also used in conjunction with other inputs to form rating assessments for the purpose of credit approval and for risk management decisions.

For wholesale business (includes corporate, bank and sovereign exposures), obligor PD is estimated using a Customer Risk Rating of 22 grades, of which 20 are non-default ratings representing varying degrees of strength of financial condition, and two are default ratings. Credit score generated by a model and/or a scorecard for individual obligor is recommended to and reviewed by credit approver taking into account all relevant information to the risk rating determination.

LGD and EAD estimation for wholesale business is subject to a HSBC Group framework of basic principles with the parameter customisation based on relevant local jurisdiction. EAD is estimated to a 12-month horizon and broadly represents the current exposure plus an estimate for future draw down on undrawn facilities. LGD focuses on the facility and collateral structure which takes into account the priority/seniority of the facility, the type and value of the collateral and past experience on the type of counterparty, which is expressed as a percentage of EAD.

The Group uses supervisory slotting criteria approach in rating its regulatory specialised lending exposure. Under this approach, rating will be assigned based on the borrower and transaction characteristics.

For retail business, a wide range of application and behavioural models used in the management of retail portfolios has been supplemented to develop the credit model for measuring PD, EAD and LGD under the IRB approach. The credit risk model typically incorporates the characteristics of the products and the borrower's account behaviour. For reporting and management information purposes, retail portfolios are analysed according to analytically-derived criteria into expected loss bands, facilitating comparability across the Group's retail customer segments, business lines and product types.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited) (continued)*

### 4 Credit risk under the internal-ratings based approach *(continued)*

#### (a) The internal rating system *(continued)*

##### (iii) Use of internal ratings

While internal estimates derived from applying the IRB approach are employed in the calculation of risk-weighted exposure amounts for the purpose of determining regulatory capital requirements, they are also used in a multitude of contexts within risk management and business processes. Such uses continue to develop and become embedded as experience grows and the repository of quality data improves. They include:

- credit approval: authorities, including those for specific counterparty types and transactions, are delegated to officers and executives in the Group's credit risk function and business division involving lending activities using a risk-based approach, tiered relative to obligor customer risk rating;

- credit risk analytical tools: IRB measures are valuable tools deployed in the assessment of customer and portfolio risk; migration of customer risk rating becomes an important indicator in credit monitoring process;

- planning: IRB risk measures and risk weighted assets at customer segment or credit portfolio levels are considered in the Group's operating plan;

- pricing: customer relationship managers apply a risk adjusted return on capital methodology in risk-weighted assets and profitability calculators; and

- portfolio management: regular reports to Credit Committee, Risk Management Committee containing analyses of risk exposures employing IRB risk metrics, e.g. by customer segment and credit quality grade.

##### (iv) Credit risk mitigation

The Group's approach when granting credit facilities is to do so on the basis of capacity to repay, rather than primarily rely on credit risk mitigation. Depending on a customer's standing and the type of product, facilities may be provided on unsecured basis. Nevertheless, mitigation of credit risk is an important aspect of effective management and takes in many forms. There is immaterial credit and market risks concentrations within the credit risk mitigation held by the Group.

The Group's general policy is to promote the use of credit risk mitigation, justified by commercial prudence and good practice as well as capital efficiency. Policies covering the acceptability, structuring, control and valuation with regard to different types of collateral security are established to ensure that they are supported by evidence and continue to fulfil their intended purpose.

The main types of recognised collateral taken by the Group are those as stated in section 80 of the Capital Rules, including (but not limited to) cash on deposit, gold bullion, equities listed in a main index and/or a recognised exchange, collective investment schemes, various recognised debt securities, residential, industrial and commercial property, etc.

It is the Group's policy that all facilities of wholesale portfolios should be reviewed (and hence collateral revalued) at least on an annual basis. Where facilities have been overdue for more than 90 days and are tangibly secured, the collateral should be revalued not less than every 3 months.

For residential mortgages portfolio under retail portfolios, valuations are conducted monthly and automatically by making reference to real estate price indices. When customer has exposure larger than HK\$50 million, in-house estimates or valuation from selected valuation firms is required upon annual review. For loans with serious delinquent or when the property is repossessed, an updated in-house valuation should be obtained. Where the market is subject to significant changes in conditions, revaluation should be more frequent.

The Group's policy provides that netting is only to be applied where it has the legal right to do so. Under the Capital Rules, recognised netting is defined as any netting done pursuant to a valid bilateral netting arrangement. Consistent with the Capital Rules, only bilateral netting arrangements are included for capital adequacy credit risk mitigation calculation. While the use of multi-lateral netting arrangement is allowed for internal credit risk management, it is not a valid credit risk mitigation under the Capital Rules.

In terms of the application within advanced IRB approach, credit risk mitigants are considered in two broad categories: first, those which reduce the intrinsic probability of default of an obligor and therefore operate as adjustments to PD estimation, and second, those which affect estimated recoverability of obligations and require adjustment of LGD. The first includes, for example, full parental or group company guarantees; the second, collateral security of various kinds such as cash, equity, properties, fixed assets such as motor vehicles, plant and machinery, stock and debtors, bank and sovereign guarantees, etc.

The adjustment of PD estimation is also subject to supplementary methodologies in respect of a "sovereign ceiling" constraining the risk ratings assigned to obligors in countries of high risk, and of partial parental support.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited) (continued)*

### 4 Credit risk under the internal-ratings based approach *(continued)*

#### (a) The internal rating system *(continued)*

##### (iv) Credit risk mitigation *(continued)*

For wholesale exposures, LGD estimates are determined with reference to the type and value of credit risk mitigant provided. For retail exposures, credit mitigation data is incorporated into the internal risk parameters for risk exposures and feeds continuously into the calculation of the expected loss band value summarising both customer delinquency and product or facility risk. Credit and risk mitigation data forms part of the inputs submitted to a centralised database, upon which a capital calculation engine then performs calculations by applying the relevant Basel II rules and approaches.

##### (v) Control mechanisms for rating systems

In order to ensure that the rating systems are robust, the Group has relevant policy and control mechanism in place to validate the accuracy and consistency of the systems, which are used for the estimation of all relevant risk components for risk management and capital adequacy calculation. Regular reporting on model performance are made to relevant management committees comprising of senior management and business representatives.

Model validation process enables the Group to reaffirm the continuing appropriateness of the models in the light of performance against expectation. The validation process involves a series of quantitative and qualitative activities to assess the rating consistency, discriminatory power, prediction power and stability of a model. The validation process covers two major aspects: pre-implementation examination and post-implementation validation.

Pre-implementation examination is performed for newly built or redeveloped risk rating models before the model is formally deployed into production environment. Pre-implementation examination is carried out by independent party not involved in the model development process. Moreover, post-implementation validation is performed periodically by the model developer with established performance benchmarking standards. There are also periodic model performance reports provided to those responsible for model oversight and model monitoring. Additionally, Internal Audit conducts annual review on model validation and monitoring processes.

#### (b) Internal rating process and risk components

For bank and sovereign exposures, the internal risk rating models are developed and managed centrally by the HSBC Group where the customer relationship is managed on a global basis. The assignment of customer risk rating is subject to policy stipulated by the HSBC Group to ensure consistency. Local assessment are conducted separately for the specific obligor within the global relationship group.

For corporate exposures, assessment on financial standing and repayment ability of the customer are critical in making the credit decision and in determining the customer risk ratings. The internal rating model is designed to assess the customer's risk profile consistently and objectively. The objective assessment by the model is supplemented by lending experience and expertise of credit approvers to ensure a comprehensive assessment is made in assigning a customer risk rating. In case information external to the model is deemed to have a material impact on default probability, an override is permissible. Justification of an override is documented for independent review and model validation purposes.

For wholesale exposures including sovereign, bank and corporate exposures, annual review of the customer's risk profile and risk rating are considered a key control point and essential credit risk management practice. In addition, credit risk policy stipulates a continuous monitoring requirement of corporate exposure by designated lending officers. Formal review and reporting is required upon any material deterioration in customer's risk profile.

For retail exposures, an homogeneous group of exposures bearing the same risk characteristics, are segmented into pools for risk rating assessment. Each exposure is assigned into a particular pool based on the assessment of the borrower and transaction risk characteristics and delinquency of exposure.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited) (continued)*

### 4 Credit risk under the internal-ratings based approach *(continued)*

#### (b) Internal rating process and risk components *(continued)*

##### (i) Probability of default ("PD")

PD is the likelihood, expressed as a percentage, of a default event in a one-year time horizon.

The model used to estimate the PD for corporate exposure is based upon a quantitative assessment of the borrower's financials combined with a qualitative assessment of the industry environment, management experience and company structure. Based on the Group's historical default data, the score generated by the PD model is calibrated into a customer risk rating.

The model used to estimate the PD for bank exposure incorporates an advanced analytical model, which combines financial statistics and trends with qualitative inputs by the relevant relationship manager. The resultant score is blended with internal country and operating environment risk scores to generate a customer risk rating.

The model used to estimate the PD for sovereign exposure incorporates both quantitative and qualitative data from a wide range of reference sources and agencies on economic, political, financial and social conditions. Separate local currency and foreign currency risk ratings and associated PD are derived and applied to exposures denominated in the respective currencies.

The model used to estimate the PD for retail exposure takes variables of facility utilisation, payment history, account conduct as well as in-house developed application or behaviour scorecards and credit bureau data.

##### (ii) Exposure at default ("EAD")

EAD is a product-specific estimate of the exposure at the time of default. This calculation is based on empirical data predicting the likelihood of drawings, over a one-year time horizon, from an analysis of statistical behaviour of such default events. It is the sum of on-balance sheet balance outstanding and amount of off-balance sheet items multiplied by the credit conversion factor and the drawdown factor. Credit conversion factor is the likelihood that a non-cash/off-balance facility may crystallise and become cash exposure whereas drawdown factor is an estimate of expected additional drawdown on an available unutilised limit.

EAD models for wholesale exposures (include corporate, bank and sovereign), are developed for variable exposure products such as lines of credit, overdraft and other commitments. The models assess the likely drawdown of unconditionally cancellable and not unconditionally cancellable limits as an exposure approaches default based on the Group's historical default and drawdown experiences and supplemented by credit expert opinion where applicable.

EAD models are developed for retail revolving exposures to predict additional customer drawdown for the estimation of EAD. EAD is estimated based on current principal outstanding for non-revolving retail exposures.

##### (iii) Loss given default ("LGD")

LGD is an estimate of the severity of the loss that the Group is likely to incur in the event that the borrower defaults, expressed as a percentage of EAD.

LGD models for wholesale exposures are developed by assessing the recovery value of different types of collateral together with the cost in securing the recoveries and timing with which such cash flows occur. LGD for unsecured exposure is estimated based on past loss data and is driven by factors such as customer type, facility seniority and regional variances.

LGD models for retail exposure is developed basing on the Group's internal loss and default experience including recovery values for different types of collaterals or different product natures. LGD is estimated on pools which have sufficient homogeneity and bear similar risk characteristics.

The estimation of LGD takes into consideration the impact on the value of different collaterals and recovery from unsecured exposures under economic downturn condition.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 4 Credit risk under the internal-ratings based approach (continued)

#### (c) Approach for determining provisions

##### Policies for Establishing Provisions

The impairment losses of loans and receivables are measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. Receivables with a short duration are not discounted if the effect of discounting is immaterial.

The total allowance for impairment losses consists of two components: individually assessed impairment allowances and collectively assessed impairment allowances. Please refer to note 4(f) to the financial statements for details of the provision policies.

All impaired loans and receivables are reviewed and analysed periodically. Any subsequent changes to the amounts and timing of the expected future cash flows compared to the prior estimates that can be linked objectively to an event occurring after the write-down, will result in a change in the impairment allowances on loans and receivables and will be charged or credited to the profit and loss account. A reversal of impairment losses is limited to the loans and receivables' carrying amount that would have been determined had no impairment loss been recognised in prior years. Where there is no reasonable prospect of recovery, the loan and the related interest receivables are written off.

The Group takes into consideration the provision made in its capital maintenance decisions as in accordance with section 220 of the Capital Rules. The Group compares the total expected loss ("EL") amount and the total eligible provisions, and if total EL amount exceeds total eligible provisions, the Group deducts the difference from the core capital and supplementary capital. On the other hand, if total EL amount is less than the eligible provisions, the Group includes the differences in its supplementary capital up to a maximum of 0.6 per cent of the Group's risk weighted amount for credit risk calculated using IRB Approach.

#### (d) Exposures subject to supervisory estimates

The following table indicates the exposure classes and the respective exposure amounts that are subject to supervisory estimates as at 31 December:

	2009	2008
<b>IRB Exposure Class</b>		
Sovereign exposures	-	50,696
Bank exposures	-	179,639
Corporate exposures	<b>19,468</b>	188,446
<b>Total EAD</b>	<b>19,468</b>	418,781

Exposure as at 31 December 2009 decreased mainly due to the migration from foundation internal ratings-based approach to advances internal ratings-based approach.

**SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS** (unaudited) (continued)

**4 Credit risk under the internal-ratings based approach** (continued)

**(e) Exposures by IRB calculation approach**

The table below shows the Group's exposures:

**2009**

	Advanced IRB approach	Supervisory slotting criteria approach	Retail IRB approach	Specific risk-weight approach	Total exposures
Sovereign exposures	76,116	-	-	-	76,116
Bank exposures	209,757	-	-	-	209,757
Corporate exposures	187,790	19,468	-	-	207,258
Retail exposures:					
- Residential mortgages to individuals and property-holding shell companies	-	-	121,912	-	121,912
- Qualifying revolving retail exposures	-	-	50,321	-	50,321
- Small business retail exposures	-	-	3,398	-	3,398
- Other retail exposures to individuals	-	-	8,597	-	8,597
Other exposures	-	-	-	15,023	15,023
	<u>473,663</u>	<u>19,468</u>	<u>184,228</u>	<u>15,023</u>	<u>692,382</u>

**2008**

	Foundation IRB approach	Supervisory slotting criteria approach	Retail IRB approach	Specific risk-weight approach	Total exposures
Sovereign exposures	50,696	-	-	-	50,696
Bank exposures	179,639	-	-	-	179,639
Corporate exposures	173,412	15,034	-	-	188,446
Retail exposures:					
- Residential mortgages to individuals and property-holding shell companies	-	-	115,053	-	115,053
- Qualifying revolving retail exposures	-	-	44,309	-	44,309
- Small business retail exposures	-	-	3,119	-	3,119
- Other retail exposures to individuals	-	-	8,817	-	8,817
Other exposures	-	-	-	14,629	14,629
	<u>403,747</u>	<u>15,034</u>	<u>171,298</u>	<u>14,629</u>	<u>604,708</u>

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 4 Credit risk under the internal-ratings based approach (continued)

#### (f) Exposures by credit risk mitigation used

The table below shows the Group's exposures (after the effect of any on-balance sheet or off-balance sheet recognised netting) which are covered by recognised guarantees after the application of haircuts required under the Capital Rules. These exposures exclude OTC derivative transactions.

	2009	2008
<b>Portfolio</b>		
Bank exposures	35,591	31,511
Corporate exposures	66,843	49,161
Retail exposures	15,722	17,522
	<u>118,156</u>	<u>98,194</u>

For the class of sovereign exposures, there were no exposures covered by recognised guarantees.

#### (g) Risk assessment for exposures under IRB approach

The tables below detail the total EAD of sovereign, bank and corporate exposures by exposure-weighted average risk-weight, exposure-weighted average PD and exposure-weighted average LGD for each obligor grade as at 31 December.

##### (i) Sovereign, bank and corporate (other than specialised lending) exposures - analysis by obligor grade

The exposure of default disclosed below in respect of sovereign, bank and corporate exposures have taken into account the effect of recognised collateral and recognised guarantees.

	2009			
	Exposure-weighted average PD %	Exposure-weighted average LGD %	Exposure-weighted average risk-weight %	Exposure at default
<b>Sovereign exposure</b>				
Minimal risk	0.01	10.08	0.93	68,919
Low risk	0.06	44.60	13.30	7,197
				<u>76,116</u>
<b>Bank exposure</b>				
Minimal risk	0.03	23.53	5.15	55,748
Low risk	0.08	29.63	12.18	123,971
Satisfactory risk	0.24	31.75	26.97	25,212
Fair default risk	1.02	42.32	74.49	4,620
Moderate default risk	2.58	31.18	73.69	136
Significant default risk	5.07	24.56	73.18	36
High default risk	12.83	20.53	92.89	34
				<u>209,757</u>
<b>Corporate exposure (other than specialised lending)</b>				
Minimal risk	0.04	38.63	14.99	19,552
Low risk	0.10	45.00	25.58	56,105
Satisfactory risk	0.40	43.29	53.32	54,318
Fair default risk	1.22	42.79	87.93	26,202
Moderate default risk	2.99	40.86	116.44	20,468
Significant default risk	6.30	44.63	160.51	5,112
High default risk	12.74	49.13	235.09	2,431
Special management	26.51	41.82	214.06	1,364
Default	100.00	51.91	-	2,238
				<u>187,790</u>



**SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS** (unaudited) (continued)

**4 Credit risk under the internal-ratings based approach** (continued)

**(g) Risk assessment for exposures under IRB approach** (continued)

(i) Sovereign, bank and corporate (other than specialised lending) exposures - analysis by obligor grade (continued)

	2008		
	Exposure-weighted average PD %	Exposure-weighted average risk-weight %	Exposure at default
<b>Sovereign exposure</b>			
Minimal risk	0.01	8.14	43,912
Low risk	0.06	22.96	6,743
Fair default risk	0.74	87.32	41
			<u>50,696</u>
<b>Bank exposure</b>			
Minimal risk	0.03	15.31	73,022
Low risk	0.08	27.03	87,035
Satisfactory risk	0.28	54.64	14,173
Fair default risk	0.82	89.85	2,352
Moderate default risk	3.56	142.93	2,850
Significant default risk	5.25	161.28	11
High default risk	11.24	211.93	36
Default	100.00	-	160
			<u>179,639</u>
<b>Corporate exposure (other than specialised lending)</b>			
Minimal risk	0.04	17.45	31,433
Low risk	0.10	29.92	53,737
Satisfactory risk	0.40	59.48	47,971
Fair default risk	1.37	99.67	19,616
Moderate default risk	3.15	117.36	12,907
Significant default risk	6.02	141.23	3,685
High default risk	10.47	153.12	573
Special management	23.59	237.45	1,159
Default	100.00	-	2,331
			<u>173,412</u>

In 2008, supervisory LGD estimates were applied for the sovereign, bank and corporate exposures (other than specialised lending) when foundation internal ratings-based approach was adopted.

(ii) Corporate exposures (specialised lending) - analysis by supervisory rating grade

	2009		2008	
	Exposure-weighted average risk-weight %	Exposure at default	Exposure-weighted average risk-weight %	Exposure at default
<b>Obligor Grade</b>				
Strong	64.32	14,460	65.42	11,225
Good	91.02	3,488	93.46	2,997
Satisfactory	121.90	1,520	121.90	527
Weak	-	-	265.00	285
		<u>19,468</u>		<u>15,034</u>

**SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS** (unaudited) (continued)

**4 Credit risk under the internal-ratings based approach** (continued)

**(g) Risk assessment for exposures under IRB approach** (continued)

(iii) Retail exposures - analysis by credit quality

The table below shows a breakdown of exposures (the EAD of on-balance sheet exposures and off-balance sheet exposures) on a pool basis by credit quality classification:

	Residential mortgages	Qualifying revolving retail exposures	Small business retail exposures	Other retail exposures	Total exposures
<b>2009</b>					
Strong	120,465	42,897	3,327	6,412	173,101
Medium	996	7,075	56	2,076	10,203
Sub-standard	-	336	-	79	415
Impaired	451	13	15	30	509
	<u>121,912</u>	<u>50,321</u>	<u>3,398</u>	<u>8,597</u>	<u>184,228</u>
<b>2008</b>					
Strong	113,287	38,329	3,030	7,376	162,022
Medium	879	5,884	80	1,343	8,186
Sub-standard	-	82	-	65	147
Impaired	887	14	9	33	943
	<u>115,053</u>	<u>44,309</u>	<u>3,119</u>	<u>8,817</u>	<u>171,298</u>

(iv) Undrawn commitments

The table below shows the amount of undrawn commitments and exposure-weighted average EAD for sovereign, bank and corporate exposures as at 31 December 2009:

	Undrawn commitments	Exposure-weighted average EAD
Sovereign exposures	-	-
Bank exposures	803	303
Corporate exposures	<u>81,348</u>	<u>32,029</u>
	<u>82,151</u>	<u>32,332</u>

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited) (continued)*

### 4 Credit risk under the internal-ratings based approach *(continued)*

#### (h) Analysis of actual loss and estimates

The table below shows the actual losses which represent the net charges (including write-offs and impairment loss allowances) made during the year.

	<b>2009</b>	2008
<b>Exposure Class</b>		
Sovereign	-	-
Bank	<b>10</b>	1,375
Corporate	<b>413</b>	1,109
Residential mortgage	<b>(59)</b>	(20)
Qualifying revolving retail	<b>463</b>	312
Other retail	<b>131</b>	73
	<u><b>958</b></u>	<u>2,849</u>

Actual loss in 2009 improved especially for the bank and corporate sectors. In 2008, these sectors suffered due to the financial tsunami and economic slowdown of major world economies. Overall economic conditions improved in 2009. This together with the risk containment measures adopted by the Group led to lower loss during the reporting period.

The table below shows the expected loss which is the estimated future loss over a one-year time horizon for different exposure classes under IRB approach.

	31 December 2008	31 December 2007
<b>Exposure Class</b>		
Sovereign	2	3
Bank	191	551
Corporate	2,141	811
Residential mortgage	231	251
Qualifying revolving retail	301	282
Other retail	107	399
	<u>2,973</u>	<u>2,297</u>

It should be noted that actual loss and expected loss are measured and calculated using different methodologies which may not be directly comparable. The limitation arises mainly from the fundamental differences in the definition of "loss" under expected loss calculation which is derived based on regulatory rules and actual loss (write-off and impairment loss allowance) which is determined based on accounting standards.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 4 Credit risk under the internal-ratings based approach (continued)

#### (h) Analysis of actual loss and estimates (continued)

The tables below set out the comparison of the predicted risk estimates of the Group's credit risk models against actual outcomes of the wholesale and retail exposures. Comparable data for LGD and EAD estimates of previous reporting period is not applicable as foundation internal ratings-based approach was adopted for the reporting year of 2008.

#### (i) Wholesale exposures

##### Risk estimates as at 31 December 2008 against actual outcome for the year 2009

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Sovereign exposure	-	0.07	-	15.95	-	100.00
Bank exposure	-	0.56	76.35	30.53	100.00	99.84
Corporate exposure	1.38	4.10	46.82	45.21	72.66	83.34

##### Risk estimates as at 31 December 2007 against actual outcome for the year 2008

	PD	
	Actual %	Estimated %
Sovereign exposure	-	0.06
Bank exposure	0.63	0.28
Corporate exposure	2.24	3.09

The actual PD rate is measured by using the number of obligor defaulted during the reporting period whereas the estimated PD rate is the long run average default rate estimated at the beginning of the reporting period. The PD estimated by internal model is calibrated to the Group's long run default experience. Hence, actual default rate in a particular year ("point-in-time") will typically differ from the estimated PD which is the "through the cycle" estimates as economies move above or below cyclical norms.

It may take more than 1 year to complete the workout process for the wholesale exposures. This creates difficulty in calculation and comparison of actual versus predicted LGD during the reporting period. The predicted LGD is the exposure weighted average LGD as of the beginning of the reporting period whereas the actual LGD is computed using the resolved default cases accumulated in 2009 which covers cases defaulted before 2009. The actual LGD of the bank exposure represents the realized loss for obligors defaulted in 2008. The relatively high loss rate was connected with the exceptional economic condition in 2008 and was the aftermath of the financial tsunami. There was minimal losses on the bank exposure in past years as well as in 2009.

The estimated EAD% represents the ratio of total model estimated exposure values to total limits at the beginning of the reporting period. The actual EAD% is the limit weighted average % which compares the realized EAD of the defaulted and resolved cases up to 2009 against the limits 1 year prior to default.

**SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS** (unaudited) (continued)

**4 Credit risk under the internal-ratings based approach** (continued)

**(h) Analysis of actual loss and estimates** (continued)

(ii) Retail exposures

Risk estimates as at 31 December 2008 against actual outcome for the year 2009

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Retail exposures:						
- Residential mortgages to individuals and property-holding shell companies	0.34	1.68	3.34	11.24	93.33	100.00
- Qualifying revolving retail exposures	0.70	0.73	89.56	86.17	89.35	85.00
- Small business retail exposures	0.87	1.43	0.05	11.48	92.06	100.00
- Other retail exposures to individuals	3.64	4.20	63.86	70.93	64.30	98.71

Risk estimates as at 31 December 2007 against actual outcome for the year 2008

	PD	
	Actual %	Estimated %
Retail exposures:		
- Residential mortgages to individuals and property-holding shell companies	0.31	1.05
- Qualifying revolving retail exposures	0.54	0.62
- Other retail exposures to individuals	2.32	5.38

(Small business retail exposures were included in other retail exposures to individuals in 2008.)

The actual PD rate is measured in the same ways as wholesale exposure.

The actual LGD for the retail exposures takes into account the 24-months recovery period and represents the realized LGD for cases defaulted during 2007 which were recovered within 24 months after default. The predicted LGD is the exposure weighted average LGD for the defaulted cases estimated prior to default.

The estimated EAD % represents the ratio of total model estimated EAD to total limits for cases defaulted during 2009 whereas the actual EAD % compares the exposure values of the cases defaulted in 2009 at the time of default against the maximum limit 1 year prior to default.

As there may be different portfolios reported under one retail asset class, portfolios with no default since model implementation are excluded from the estimated and actual comparison of the asset class concerned to eliminate distortion.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited) (continued)*

### 5 Credit risk under the standardised (credit risk) approach

#### (a) Ratings from External Credit Assessment Institutions ("ECAIs")

The Group uses the following ECAIs to calculate its capital adequacy requirements under the standardised (credit risk) approach prescribed in the Capital Rules:

- Fitch Ratings
- Moody's Investors Service
- Standard & Poor's Ratings Services, and
- Rating and Investment Information, Inc.

Where exposures have been rated by the above-mentioned ECAIs, they are categorised under the following class of exposures:

- Sovereign exposures
- Public sector entity exposures
- Multilateral development bank exposures
- Bank exposures
- Securities firm exposures
- Corporate exposures
- Collective investment scheme exposures

The process used to map ECAIs issuer ratings or ECAIs issue specific ratings in the Group's banking book is consistent with those prescribed in the Capital Rules.

#### (b) Credit risk mitigation

The Group's policies on credit risk mitigation under standardised approach align with those under the internal ratings-based approach.

As stated in sections 98 and 99 of the Capital Rules, certain guarantees and credit derivative contracts are recognised for credit risk mitigation purposes. The main types of guarantees are from sovereigns, corporate and banks. With corporate guarantees, in order for it to be recognised as a credit risk mitigants, it must have a credit rating of A- or better by Standard & Poor's Ratings Services, Fitch Ratings and Rating and Investment Information, Inc, or a credit rating of A3 or better by Moody's Investors Service. With sovereign and bank guarantees, these exposures are managed by central teams in HSBC Group Head Office in London.

There is immaterial credit and market risks concentrations within the credit risk mitigants (recognised collateral and guarantees) used by the Group.

**SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS** (unaudited) (continued)

**5 Credit risk under the standardised (credit risk) approach** (continued)

**(c) Credit risk exposures under the standardised (credit risk) approach**

2009

Class of exposures	Total exposures*	Exposures after recognised credit risk mitigation		Risk-weighted amounts		Total risk-weighted amounts	Total exposures covered by recognised collateral	Total exposures covered by recognised guarantees or recognised credit derivative contracts
		Rated	Unrated	Rated	Unrated			
<b>On-balance sheet</b>								
Sovereign	-	-	2,002	-	-	-	-	-
Public sector entity	14,882	14,327	69	1,107	14	1,121	-	490
Multilateral development bank	16,094	16,094	-	-	-	-	-	-
Bank	39	-	39	-	12	12	-	-
Securities firm	-	-	-	-	-	-	-	-
Corporate	11,974	397	3,502	198	3,701	3,899	6,644	1,431
Collective investment scheme	48	-	48	-	48	48	-	-
Cash items	-	-	-	-	-	-	-	-
Regulatory retail	2,721	-	2,529	-	1,896	1,896	111	81
Residential mortgage loan	14,256	-	14,239	-	8,753	8,753	13	4
Other exposures which are not past due exposures	5,435	-	4,987	-	4,987	4,987	448	-
Past due exposures	400	-	400	-	598	598	4	-
	<u>65,849</u>	<u>30,818</u>	<u>27,815</u>	<u>1,305</u>	<u>20,009</u>	<u>21,314</u>	<u>7,220</u>	<u>2,006</u>
<b>Off-balance sheet</b>								
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	2,070	129	1,602	26	1,573	1,599	339	14
OTC derivative contracts	196	3	193	1	183	184	-	-
Credit derivative contracts	-	-	-	-	-	-	-	-
Other off-balance sheet exposures not elsewhere specified	-	-	-	-	-	-	-	-
	<u>2,266</u>	<u>132</u>	<u>1,795</u>	<u>27</u>	<u>1,756</u>	<u>1,783</u>	<u>339</u>	<u>14</u>
<b>Total</b>	<u><b>68,115</b></u>	<u><b>30,950</b></u>	<u><b>29,610</b></u>	<u><b>1,332</b></u>	<u><b>21,765</b></u>	<u><b>23,097</b></u>	<u><b>7,559</b></u>	<u><b>2,020</b></u>
Exposures deducted from capital base	<u>-</u>							

\* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

**SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)**

**5 Credit risk under the standardised (credit risk) approach (continued)**

**(c) Credit risk exposures under the standardised (credit risk) approach (continued)**

2008

Class of exposures	Total exposures*	Exposures after recognised credit risk mitigation		Risk-weighted amounts		Total risk-weighted amounts	Total exposures covered by recognised collateral	Total exposures covered by recognised guarantees or recognised credit derivative contracts
		Rated	Unrated	Rated	Unrated			
<b>On-balance sheet</b>								
Sovereign	-	-	-	-	-	-	-	-
Public sector entity	2,702	2,706	-	541	-	541	-	-
Multilateral development bank	3,976	3,976	-	-	-	-	-	-
Bank	895	81	814	16	169	185	-	-
Securities firm	-	-	-	-	-	-	-	-
Corporate	12,859	2,853	4,027	934	4,028	4,962	5,979	-
Collective investment scheme	72	-	72	-	72	72	-	-
Cash items	-	-	-	-	-	-	-	-
Regulatory retail	2,487	-	2,371	-	1,778	1,778	116	-
Residential mortgage loan	11,889	-	11,873	-	7,331	7,331	12	4
Other exposures which are not past due exposures	6,347	-	5,844	-	5,844	5,844	503	-
Past due exposures	301	-	301	-	446	446	5	-
	<u>41,528</u>	<u>9,616</u>	<u>25,302</u>	<u>1,491</u>	<u>19,668</u>	<u>21,159</u>	<u>6,615</u>	<u>4</u>
<b>Off-balance sheet</b>								
<b>Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts</b>								
OTC derivative contracts	2,606	1,231	1,375	302	1,348	1,650	593	-
OTC derivative contracts	482	14	468	3	430	433	-	-
Credit derivative contracts	-	-	-	-	-	-	-	-
Other off-balance sheet exposures not elsewhere specified	-	-	-	-	-	-	-	-
	<u>3,088</u>	<u>1,245</u>	<u>1,843</u>	<u>305</u>	<u>1,778</u>	<u>2,083</u>	<u>593</u>	<u>-</u>
<b>Total</b>	<u><u>44,616</u></u>	<u><u>10,861</u></u>	<u><u>27,145</u></u>	<u><u>1,796</u></u>	<u><u>21,446</u></u>	<u><u>23,242</u></u>	<u><u>7,208</u></u>	<u><u>4</u></u>
Exposures deducted from capital base	<u><u>-</u></u>							

\* Principal amount or credit equivalent amount, as applicable, net of specific provisions.



## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited) (continued)*

### 6 Counterparty credit risk-related exposures

- (a) In respect of counterparty credit risk exposures which arises from over-the-counter ("OTC") derivative transactions and repo-style transactions (referred as "relevant transaction") hereunder, credit limit to counterparty credit risk arising from the relevant transaction is assigned, monitored and reported in accordance with the Group risk methodology. The credit limit established takes into account the gross contract amount and the future potential exposure measured on the basis of 95 percentile potential worst case loss estimates for the product involved. This method of calculating credit limit applies to all counterparties.

Credit equivalent amount and risk weighted amount of relevant transaction is determined following the regulatory capital requirements. Risk-weighted amount is calculated in accordance with the counterparty risk weighting as per internal ratings-based approach/standardised (credit risk) approach under the Capital Rules.

The policy for secured collateral on derivatives is guided by the Group's internal Best Practice Guidelines ensuring the due-diligence necessary to fully understand the effectiveness of netting and collateralisation by jurisdiction, counterparty, product and agreement type is fully assessed and that the due-diligence standards are high and consistently applied. The Group's policies for establishing provisions are discussed in note 4(f) - Loan impairment.

#### (b) Counterparty credit risk exposures

The following tables show the counterparty credit risk exposures under the internal-ratings based approach and standardised (credit risk) approach. There was no outstanding repo-style transactions and credit derivative contracts at 31 December 2009 (2008: Nil).

##### (i) Counterparty credit risk exposures under the internal-ratings based approach

	2009	2008
<b>OTC derivative transactions:</b>		
Gross total positive fair value which are not repo-style transactions	4,398	6,233
Credit equivalent amount	10,135	14,004
Value of recognised collateral by type:		
Debt securities	-	-
Others	-	-
	<u>-</u>	<u>-</u>
Credit equivalent amount or net credit exposures net of recognised collateral held	<u>10,135</u>	<u>14,004</u>
Risk-weighted amount	<u>1,499</u>	<u>3,677</u>
Notional amount of recognised credit derivative contracts which provide credit protection	<u>-</u>	<u>-</u>

##### (ii) Counterparty credit risk exposures under the standardised (credit risk) approach

	2009	2008
<b>OTC derivative transactions:</b>		
Gross total positive fair value which are not repo-style transactions	119	345
Credit equivalent amount	196	482
Value of recognised collateral by type:		
Debt securities	-	-
Others	-	-
	<u>-</u>	<u>-</u>
Credit equivalent amount or net credit exposures net of recognised collateral held	<u>196</u>	<u>482</u>
Risk-weighted amount	<u>184</u>	<u>433</u>
Notional amount of recognised credit derivative contracts which provide credit protection	<u>-</u>	<u>-</u>

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 6 Counterparty credit risk-related exposures (continued)

#### (c) Major classes of exposures by counterparty type

(i) Major classes of exposures under the internal ratings-based approach by counterparty type

	2009			2008		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
Sovereign	-	-	-	1,766	18	4
Public sector entities	-	-	-	-	-	-
Banks	582,150	9,081	878	763,517	12,753	3,082
Corporates	37,478	1,054	621	44,845	1,233	591
	<u>619,628</u>	<u>10,135</u>	<u>1,499</u>	<u>810,128</u>	<u>14,004</u>	<u>3,677</u>

(ii) Major classes of exposures under the standardised (credit risk) approach by counterparty type

	2009			2008		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
Sovereign	-	-	-	-	-	-
Public sector entities	438	3	1	1,436	15	3
Banks	-	-	-	-	-	-
Corporates	3,212	193	183	4,433	467	430
	<u>3,650</u>	<u>196</u>	<u>184</u>	<u>5,869</u>	<u>482</u>	<u>433</u>

### 7 Asset securitisation

There was no asset securitisation for which the Group is an originating institution or an investing institution at 31 December 2009 (2008: Nil).

### 8 Market risk

The HKMA has granted approval under section 18(2)(a) and 18(5) of the Capital Rules for the Group to use the internal models approach to calculate its market risk for foreign exchange risk and general interest rate risk. Standardised approach is used for the calculation of specific interest rate risk, equity risk and commodity risk.

	2009	2008
Market risk calculated by:		
- Internal models approach:		
-- foreign exchange exposures and general interest rate exposures	91	114
- Standardised approach:		
-- specific interest rate exposures	10	20
-- equity exposures	1	1
Total capital charge for market risk	<u>102</u>	<u>135</u>

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 9 Operational risk

The HKMA has granted approval under section 25(2) of the Capital Rules for the Group to use the standardised approach to calculate its operational risk.

	<b>2009</b>	2008
Capital charge for operational risk	<u><b>3,121</b></u>	<u>3,048</u>

### 10 Equity exposures in banking book

Investments in equity shares which are intended to be held on a continuing basis, but which do not comprise investments in associates, jointly controlled entities or subsidiaries, are classified as available-for-sale securities and are reported in the balance sheet as "Financial investments". Available-for-sale securities are measured at fair value as described in notes 4(g)(iii) and 4(n) on the financial statements. Included within this category are investments made by the Group for strategic purposes, which are subject to additional internal procedures and approvals to ensure that the investment is in accordance with the Group's strategy and to ensure compliance with all relevant regulatory and legal restrictions. In some cases, additional investments may be made later such that the investee becomes an associate, jointly controlled entity or subsidiary, at which point the investment is reclassified in accordance with the Group's accounting policies.

	<b>2009</b>	2008
Cumulative realised gains on disposal	<b>161</b>	255
Unrealised gains:		
- recognised in reserve but not through the income statement	<b>199</b>	254
- deducted from the supplementary capital	-	-

### 11 Disclosure for selected exposure

#### (a) Holding of debt securities issued by Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation

The table below shows the Group's exposures to the senior debt securities (AAA rated) issued by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

	Gross principal	Fair value
<b>At 31 December 2009</b>	<u><b>45</b></u>	<u><b>47</b></u>
At 31 December 2008	<u>63</u>	<u>66</u>

The Group did not hold any asset-backed securities, mortgage-backed securities and collateralised debt obligations.

#### (b) Involvement with Special Purpose Entities (SPEs)

From time to time, the Group enters into certain transactions with customers in the ordinary course of business which involve the establishment of SPEs. 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.

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 12 Analysis of gross advances to customers by categories based on internal classification used by the Group

Gross advances, impaired advances, individually assessed and collectively assessed loan impairment allowances in respect of industry sectors which constitute not less than 10 per cent of gross advances to customers are analysed as follows:

	Group					Advances written off during the year
	Gross advances	Impaired advances	Individually assessed loan impairment allowances	Collectively assessed loan impairment allowances	New impairment allowances	
<b>2009</b>						
Residential mortgages	116,746	308	(5)	(87)	2	2
Commercial, industrial and international trade	61,676	1,615	(972)	(484)	520	384
Commercial real estate	31,987	1	-	(3)	-	-
Other property-related lending	63,166	256	(70)	(76)	25	2
<b>2008</b>						
Residential mortgages	107,187	403	(33)	(104)	22	3
Commercial, industrial and international trade	62,464	2,030	(1,048)	(483)	996	101
Commercial real estate	34,354	2	-	(5)	1	-
Other property-related lending	57,979	265	(75)	(55)	85	3

### 13 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 overseas branches and overseas subsidiaries only.

	On-balance sheet exposure	Off-balance sheet exposure	Total exposures	Individually assessed allowances
<b>2009</b>				
Mainland entities	9,241	1,911	11,152	-
Companies and individuals outside Mainland where the credit is granted for use in Mainland	6,644	2,653	9,297	50
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	45	-	45	-
	<u>15,930</u>	<u>4,564</u>	<u>20,494</u>	<u>50</u>
Exposures incurred by the Bank's mainland subsidiary	<u>28,038</u>	<u>10,095</u>	<u>38,133</u>	<u>183</u>
	<u><u>43,968</u></u>	<u><u>14,659</u></u>	<u><u>58,627</u></u>	<u><u>233</u></u>
<b>2008</b>				
Mainland entities	10,129	2,072	12,201	-
Companies and individuals outside Mainland where the credit is granted for use in Mainland	7,292	3,956	11,248	170
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	15	-	15	-
	<u>17,436</u>	<u>6,028</u>	<u>23,464</u>	<u>170</u>
Exposures incurred by the Bank's mainland subsidiary	<u>26,577</u>	<u>7,860</u>	<u>34,437</u>	<u>290</u>
	<u><u>44,013</u></u>	<u><u>13,888</u></u>	<u><u>57,901</u></u>	<u><u>460</u></u>

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 14 Cross-border claims

Cross-border claims include receivables and loans and advances, and balances due from banks and holdings of certificates of deposit, bills, promissory notes, commercial paper and other negotiable debt instruments, as well as accrued interest and overdue interest on these assets. Claims are classified according to the location of the counterparties after taking into account the transfer of risk. For a claim guaranteed by a party situated in a country different from the counterparty, the risk will be transferred to the country of the guarantor. For a claim on the branch of a bank or other financial institutions, the risk will be transferred to the country where its head office is situated. Claims on individual countries or areas, after risk transfer, amounting to 10 per cent or more of the aggregate cross-border claims are shown as follows:

	Banks & other financial institutions	Public sector entities	Sovereign & other	Total
<b>2009</b>				
Asia-Pacific excluding Hong Kong:				
- China	24,034	-	16,124	40,158
- Japan	8,320	-	45,952	54,272
- Other	37,436	589	8,140	46,165
	69,790	589	70,216	140,595
The Americas:				
- United States	39,941	45	10,259	50,245
- Other	4,762	694	13,005	18,461
	44,703	739	23,264	68,706
Europe:				
- United Kingdom	37,510	-	4,066	41,576
- Other	47,799	12,454	7,990	68,243
	85,309	12,454	12,056	109,819
<b>2008</b>				
Asia-Pacific excluding Hong Kong:				
- China	13,539	-	11,202	24,741
- Japan	8,933	-	74,127	83,060
- Other	37,300	-	6,485	43,785
	59,772	-	91,814	151,586
The Americas:				
- United States	34,673	25	34,206	68,904
- Other	10,800	-	10,805	21,605
	45,473	25	45,011	90,509
Europe:				
- United Kingdom	36,069	-	5,825	41,894
- Other	46,939	-	6,407	53,346
	83,008	-	12,232	95,240

## ANALYSIS OF SHAREHOLDERS

As at 31 December 2009	Shareholders		Shares of HK\$5 each	
	Number	Percentage of total	Number in millions	Percentage of total
<b>Number of shares held</b>				
1 - 500	6,392	33.37	1.6	0.08
501 - 2,000	6,092	31.81	7.4	0.39
2,001 - 5,000	3,189	16.65	10.9	0.57
5,001 - 20,000	2,633	13.75	26.7	1.40
20,001 - 50,000	550	2.87	17.2	0.90
50,001 - 100,000	162	0.85	11.8	0.62
100,001 - 200,000	76	0.39	10.8	0.56
Over 200,000	59	0.31	1,825.4	95.48
	<b>19,153</b>	<b>100.00</b>	<b>1,911.8</b>	<b>100.00</b>

### Geographical Distribution

Hong Kong	18,776	98.03	1,908.3	99.81
Malaysia	74	0.39	0.5	0.02
Singapore	47	0.24	2.0	0.10
Macau	32	0.17	0.1	0.01
Canada	62	0.32	0.1	0.01
United Kingdom	38	0.20	0.1	0.01
United States of America	46	0.24	0.4	0.02
Australia	44	0.23	0.1	0.01
Others	34	0.18	0.2	0.01
	<b>19,153</b>	<b>100.00</b>	<b>1,911.8</b>	<b>100.00</b>

## **SUBSIDIARIES \***

Everlasting International Limited  
Fulcher Enterprises Company Limited  
Full Wealth Investment Limited  
Hang Seng Asset Management Pte Ltd  
Hang Seng Bank (Bahamas) Limited  
Hang Seng Bank (China) Limited  
Hang Seng Bank (Trustee) Limited  
Hang Seng Bank Trustee International Limited  
Hang Seng Bullion Company Limited  
Hang Seng Credit Limited  
Hang Seng Credit (Bahamas) Limited  
Hang Seng Data Services Limited  
Hang Seng Finance Limited  
Hang Seng Finance (Bahamas) Limited  
Hang Seng Financial Information Limited  
Hang Seng Futures Limited  
Hang Seng General Insurance (Hong Kong) Company Limited  
Hang Seng Indexes Company Limited  
Hang Seng Insurance Company Limited  
Hang Seng Insurance (Bahamas) Limited  
Hang Seng Investment Management Limited  
Hang Seng Investment Services Limited  
Hang Seng Life Limited  
Hang Seng (Nominee) Limited  
Hang Seng Real Estate Management Limited  
Hang Seng Security Management Limited  
Hang Seng Securities Limited  
Haseba Investment Company Limited  
Hayden Lake Limited  
High Time Investments Limited  
HSI International Limited  
Imenson Limited  
Mightyway Investments Limited  
Silver Jubilee Limited  
Yan Nin Development Company Limited

\* As defined in Section 2 of Hong Kong Companies Ordinance.

# CORPORATE INFORMATION AND CALENDAR

## Corporate Information

### Honorary Senior Advisor to the Bank

The Honourable Lee Quo-Wei GBM, JP

## Board of Directors

### Chairman

Raymond K F Ch'ien GBS, CBE, JP

### Vice-Chairman

Margaret Leung JP

### Directors

John C C Chan GBS, JP

Marvin K T Cheung DBA(Hon), GBS, SBS, OBE, JP

Alexander A Flockhart CBE

Jenkin Hui

William W Leung BBS, JP

Eric K C Li FCPA(Practising), GBS, OBE, JP

Vincent H S Lo GBS, JP

Iain J Mackay

Dorothy K Y P Sit

Richard Y S Tang MBA, BBS, JP

Peter T S Wong JP

### Secretary

C C Li

## Registered Office

83 Des Voeux Road Central, Hong Kong

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SWIFT: HASE HK HH

Website: [www.hangseng.com](http://www.hangseng.com)

## Stock Code

The Stock Exchange of Hong Kong Limited: 11

## Registrars

Computershare Hong Kong Investor Services Limited

Shops 1712-1716, 17th Floor, Hopewell Centre

183 Queen's Road East, Wanchai, Hong Kong



## **Depository \***

The Bank of New York Mellon  
BNY Mellon Shareowner Services  
PO Box 358516  
Pittsburgh, PA 15252-8516, USA  
Telephone: 1-201-680-6825  
Toll free (domestic): 1-888-BNY-ADRS  
Website: [www.bnymellon.com/shareowner](http://www.bnymellon.com/shareowner)  
Email: [shrrelations@bnymellon.com](mailto:shrrelations@bnymellon.com)

\* The Bank offers investors in the United States a Sponsored Level-1 American Depositary Receipts Programme through The Bank of New York Mellon.

## **Annual Report 2009**

The Annual Report 2009 in both English and Chinese is now available in printed form and on the Bank's website: [www.hangseng.com](http://www.hangseng.com).

Shareholders who:

- A) receive this Annual Report 2009 by electronic means and wish to receive a printed copy; or
- B) receive this Annual Report 2009 in either English or Chinese and wish to receive a printed copy of the other language version,

may send a notice in writing to the Bank's Registrars:

Computershare Hong Kong Investor Services Limited  
17M Floor, Hopewell Centre  
183 Queen's Road East  
Wanchai, Hong Kong  
Facsimile: (852) 2529 6087  
Email: [hangseng@computershare.com.hk](mailto:hangseng@computershare.com.hk)

Shareholders who have chosen to receive this Annual Report 2009 by electronic means through the Bank's website and who, for any reason, have difficulty in receiving or gaining access to this Annual Report 2009, may submit a written request to the Bank's Registrars, Computershare Hong Kong Investor Services Limited, and will be sent this Annual Report 2009 in printed form free of charge.

Shareholders may change their choice of language or means of receipt of the Bank's future corporate communications at any time, free of charge, by completing and sending to the Bank's Registrars, Computershare Hong Kong Investor Services Limited, by post or by email ([hangseng@computershare.com.hk](mailto:hangseng@computershare.com.hk)), a change request form which can be obtained from the Bank's Registrars.

## Calendar

### 2009 Full Year Results

Announcement date 1 March 2010

### 2009 Fourth Interim Dividend\*

Announcement date 1 March 2010

Book close and record date 16 March 2010

Payment date 31 March 2010

### 2009 Annual Report

to be posted to shareholders in late March 2010

### Annual General Meeting

to be held on 14 May 2010

### 2010 Half Year Results

Announcement date 2 August 2010

### 2010 Interim Report

to be posted to shareholders in late August 2010

### *Proposed dates for 2010:*

#### 2010 First Interim Dividend

Announcement date 4 May 2010

Book close and record date 19 May 2010

Payment date 3 June 2010

#### 2010 Second Interim Dividend

Announcement date 2 August 2010

Book close and record date 17 August 2010

Payment date 1 September 2010

#### 2010 Third Interim Dividend

Announcement date 1 November 2010

Book close and record date 16 November 2010

Payment date 1 December 2010

#### 2010 Full Year Results

Announcement date 28 February 2011

#### 2010 Fourth Interim Dividend

Announcement date 28 February 2011

Book close and record date 15 March 2011

Payment date 30 March 2011

\* The Register of Shareholders of the Bank will be closed on Tuesday, 16 March 2010, during which no transfer of shares can be registered. To qualify for the fourth interim dividend, all transfers, accompanied by the relevant share certificates, must be lodged with the Bank's Registrars, Computershare Hong Kong Investor Services Limited, Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong, for registration not later than 4:30 pm on Monday, 15 March 2010. The fourth interim dividend will be payable on Wednesday, 31 March 2010 to shareholders on the Register of Shareholders of the Bank on Tuesday, 16 March 2010. Shares of the Bank will be traded ex-dividend as from Friday, 12 March 2010.