



恒生銀行  
HANG SENG BANK

# Annual Report 2008

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## 2008年年報

The printed version of Hang Seng Bank's Annual Report 2008  
will replace this version in late March 2009.

恒生銀行2008年年報之印刷本將於2009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 30 largest listed banks in the world in terms of market capitalisation (HK\$194.4 billion as at the end of December 2008).

In Hong Kong, we serve over one-third of the population through more than 210 service outlets, including 106 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 33 outlets in Beijing, Shanghai, Guangzhou, Shenzhen, Dongguan, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin and Kunming.

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

## RESULTS IN BRIEF

	2008	2007	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>16,501</b>	18,365	-10.1
Operating profit	<b>13,725</b>	17,789	-22.8
Profit before tax	<b>15,878</b>	21,471	-26.0
Profit attributable to shareholders	<b>14,099</b>	18,242	-22.7
	<b>HK\$</b>	<b>HK\$</b>	<b>%</b>
Earnings per share	<b>7.37</b>	9.54	-22.7
Dividends per share	<b>6.30</b>	6.30	0.0
<b>At year-end</b>	<b>HK\$m</b>	<b>HK\$m</b>	<b>%</b>
Shareholders' funds	<b>51,626</b>	56,456	-8.6
Total assets	<b>762,168</b>	745,999	2.2
<b>Ratios</b>	<b>%</b>	<b>%</b>	
<i>For the year</i>			
Return on average shareholders' funds	<b>26.0</b>	35.4	
Cost efficiency ratio	<b>29.2</b>	26.6	
Average liquidity ratio	<b>46.4</b>	52.9	
<i>At year-end</i>			
Capital adequacy ratio*	<b>12.5</b>	11.2	
Core capital ratio*	<b>9.5</b>	8.4	

\* Capital ratios at 31 December 2008 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 "foundation internal ratings-based approach" ("FIRB") to calculate the risk-weighted assets for credit risk from 1 January 2008, the Bank used the FIRB approach to calculate its credit risk exposure at 31 December 2008. 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 2007 were calculated using the standardised (credit risk) approach ("STC"). As there are significant differences between the FIRB and STC approaches, the capital ratios of the two periods are not directly 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.

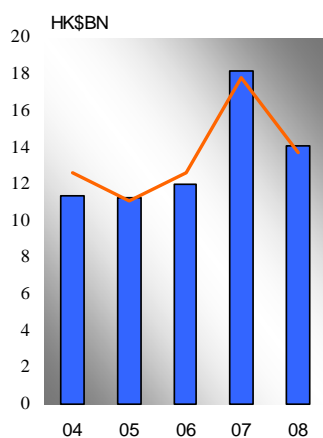
## FIVE-YEAR FINANCIAL SUMMARY

	2004	2005	2006	2007	2008
<b>For the year</b>	HK\$bn	HK\$bn	HK\$bn	HK\$bn	HK\$bn
Operating profit	12.6	11.1	12.6	17.8	13.7
Profit before tax	13.3	13.4	14.4	21.5	15.9
Profit attributable to shareholders	11.4	11.3	12.0	18.2	14.1
<b>At year-end</b>	HK\$bn	HK\$bn	HK\$bn	HK\$bn	HK\$bn
Shareholders' funds	40.9	42.6	47.0	56.5	51.6
Issued and paid up capital	9.6	9.6	9.6	9.6	9.6
Total assets	546.9	580.8	669.1	746.0	762.2
<b>Per share</b>	HK\$	HK\$	HK\$	HK\$	HK\$
Earnings per share	5.94	5.93	6.30	9.54	7.37
Dividends per share	5.20	5.20	5.20	6.30	6.30
<b>Ratios</b>	%	%	%	%	%
Post-tax return on average shareholders' funds	28.5	27.5	27.4	35.4	26.0
Post-tax return on average total assets	2.2	2.0	1.9	2.6	1.9
Capital adequacy ratio *	12.0	12.8	13.6	11.2	12.5
Core capital ratio *	10.8	10.4	10.7	8.4	9.5
Cost efficiency ratio	26.4	28.0	29.0	26.6	29.2

\* Capital ratios at 31 December 2008 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 "foundation internal ratings-based approach" ("FIRB") to calculate the risk-weighted assets for credit risk from 1 January 2008, the Bank used the FIRB approach to calculate its credit risk exposure at 31 December 2008. 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 2007 were calculated using the standardised (credit risk) approach ("STC"). As there are significant differences between the FIRB and STC approaches, the capital ratios of the two periods are not directly comparable.

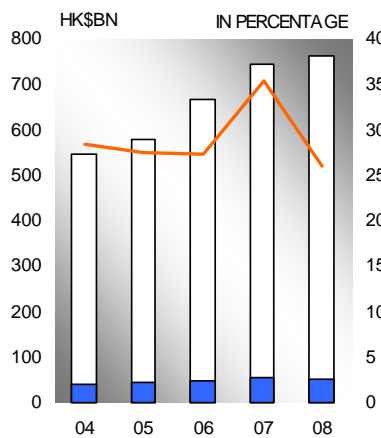
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### RESULTS



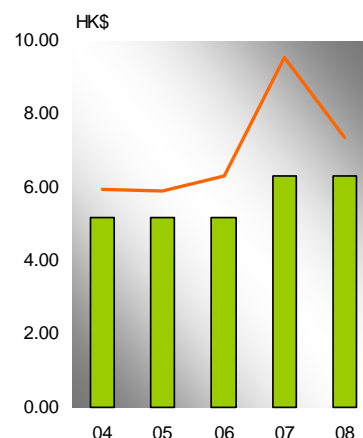
■ ATTRIBUTABLE PROFIT  
 — OPERATING PROFIT

### 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

## MAJOR MILESTONES

### January – March

- Hang Seng celebrates its 75<sup>th</sup> anniversary with a programme of special events, culminating in a large-scale cocktail reception at Hong Kong Convention and Exhibition Centre in March
- Tianhe North Road sub-branch in Guangzhou opens

### April – June

- Shenzhen branch relocates to Futian district and original premises in Luohu district becomes a sub-branch
- Futian East Pacific Garden sub-branch in Shenzhen opens
- Hang Seng Mainland China Bond Fund launched, becoming the first Securities and Futures Commission-authorized fund to directly invest in the Mainland bond market through a Qualified Foreign Institutional Investor
- First sub-branch in Nanjing opens
- Dongdan sub-branch in Beijing opens
- Zhaojiabang Road sub-branch in Shanghai opens
- Chang An sub-branch in Dongguan opens

### July – September

- Hang Seng China launches a Qualified Domestic Institutional Investor fund-linked investment product
- Wu Yang Xin Cheng sub-branch in Guangzhou opens
- Hang Seng China launches a partially capital protected structured product

### October – December

- Tianjin branch opens
- Staff training centre in Shenzhen opens
- Kunming branch opens, becoming the first locally incorporated foreign bank branch in Yunnan province
- Hang Seng acquires 20 per cent of the enlarged share capital of Yantai City Commercial Bank in Shandong province for RMB800 million, becoming the bank's largest shareholder

# RECOGNITION

## AWARDS

**Asia's Best Banker Award and Asia's Best Brand Award**  
*21<sup>st</sup> Century Business Herald*

**Best Domestic Bank – Hong Kong**  
*Asiamoney*

**Best Domestic Bank in Hong Kong**  
*The Asset*

**Hong Kong House of the Year**  
*Asia Risk*

**Excellence in Wealth Management Award**  
*The Asian Banker*

**No. 1 for Financial Reputation and for Corporate Reputation (Hong Kong Category)**  
*Asia's 200 Most-Admired Companies, Wall Street Journal Asia*

**No. 1 Bank for Return on Equity**  
*FinanceAsia 100, FinanceAsia*

**No. 2 for Return on Equity and for Return on Assets (Hong Kong Category)**  
*Asia Banks 300, Yazhou Zhoukan*

**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 2008*

**Personal Wealth Management Star Performer (Hang Seng China)**  
*Hurun Report*

**Ten Best Bank Financial Products in China (Hang Seng China – Equity-Linked Partially Capital Protected Investment Product – 'Daily Chance')**  
*Moneyweek*

**Top Ten Bank Financial Products (Hang Seng China – Equity-Linked Partially Capital Protected Investment Product – 'Daily Chance')**  
*Shanghai Securities News*

**Best Overall Investor Relations by a Hong Kong Company (Large Cap)**  
*IR Magazine*

**Bronze Award (General Category)**  
*Best Annual Reports Awards, Hong Kong Management Association*

**Best Annual Report, Best Financial Statements and Best Sustainability Statement (Asia Category)**  
*Asia Bank Corporate Reporting Awards, Lafferty Group*

**Silver Award (Environment Category)**  
*China International Public Relations Association*

**Caring Company**  
*Hong Kong Council of Social Service*

**No. 4 for CSR Disclosure**  
*CSR Asia Business Barometer*



## 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	Stable
<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

Hang Seng recorded good results in the first half of 2008, but the deepening of the global financial crisis posed significant challenges during the second half, leading to a 16 per cent drop in attributable profit for the full year after excluding the dilution gain recorded in 2007 on our strategic investment in Industrial Bank.

Net interest income for the year rose by 10.3 per cent on the back of higher margins on Treasury's balance sheet management portfolio as well as steady growth in average customer advances and improved loan spreads. However, this was outweighed by the decline in non-interest income, particularly net fee income which fell by 27.8 per cent with reduced customer appetite for investments.

Wealth management income grew during the first six months of the year, but declined sharply in the volatile market conditions of the second half. Encouraging broad-based growth in Commercial Banking income and a strong rise in Treasury earnings were offset by higher loan impairment charges and other credit risk provisions.

We continued to expand the capabilities and reach of our mainland China operations, leading to rises in customer base and total operating income, but investment in business development, currency revaluation losses and increased loan impairment charges resulted in a drop in profit before tax. We recorded increased returns on our investment in Mainland associate Industrial Bank.

Operating profit excluding loan impairment charges and other credit risk provisions fell by 10.1 per cent to HK\$16,501 million. Operating profit was down 22.8 per cent at HK\$13,725 million, reflecting the 381.9 per cent increase in loan impairment charges and other credit risk provisions to HK\$2,776 million.

Attributable profit for 2008 was HK\$14,099 million, a drop of 22.7 per cent. Earnings per share were down 22.7 per cent at HK\$7.37.

Net operating income before loan impairment charges and other credit risk provisions fell by HK\$1,719 million, or 6.9 per cent. Operating expenses rose by 2.2 per cent, due to investment in our Mainland business. Excluding Mainland operations, tighter cost control and lower performance-related payments saw operating expenses fall by 2.7 per cent. Our cost efficiency ratio was 29.2 per cent.

Profit before tax fell by 26 per cent to HK\$15,878 million. Excluding the 2007 dilution gain, profit before tax was down 20.6 per cent.

As at 31 December 2008, our capital adequacy ratio and core capital ratio were 12.5 per cent and 9.5 per cent respectively, as calculated in accordance with the 'foundation internal ratings-based approach' under Basel II.

Return on average shareholders' funds was 26 per cent, compared with 35.4 per cent (32.6 per cent excluding the dilution gain) a year earlier. Return on average total assets was 1.9 per cent, down 0.7 percentage points.

The Directors have declared a fourth interim dividend of HK\$3 per share, payable on 31 March 2009. This brings the total distribution for 2008 to HK\$6.30 per share, the same as in 2007.

### Outlook

In the worsening global financial crisis, many major economies are experiencing sharp downturns.

Declining exports and a slowdown in consumer spending has led to quarter-on-quarter economic contraction in Hong Kong since the second quarter of 2008 and unemployment is on an upward trend.

With major markets in recession, export demand will continue to fall over the short to medium term. Domestic demand is also likely to further weaken, although this should be moderated by government-led fiscal stimulus initiatives such as investment in infrastructure and other supportive measures.

Hang Seng is a well-capitalised bank with solid fundamentals and a thoughtful approach to business

that provides a strong anchor in the current financial storm.

We will focus on leveraging our competitive advantages, including our well-respected brand, strong customer relationships and comprehensive portfolio of products and services.

We have established a Risk Management Committee to oversee all of the Bank's risks.

Our leading market position relies in large part on the professionalism and dedication of our people. I wish to thank staff at all levels for their continuing commitment to providing world-class service. Our long-standing emphasis on working together – both internally and in trusted relationships with customers and business partners – will remain a key element of our strength.

Mr Raymond Or will retire from his position as Vice-Chairman and Chief Executive of Hang Seng following the Bank's Annual General Meeting (AGM) on 6 May 2009. On behalf of the Board, I would like to thank him for his outstanding contributions. His strong leadership has been instrumental in enhancing Hang Seng's status as a world-class bank. We also owe him our gratitude for strengthening the Bank's position in the industry in terms of customer service, branding and corporate responsibility. We wish him all the best for his retirement.

Mr Or's position will be taken up by Mrs Margaret Leung, who is currently Group General Manager and Global Co-Head Commercial Banking for the HSBC Group. Mrs Leung will be appointed a non-executive Director of the Bank with effect from 1 April 2009. The Board extends a warm welcome to Mrs Leung, who will benefit Hang Seng with her broad range of valuable banking experience and great leadership skills.

Independent non-executive Directors Dr Cheng Yu Tung and Dr David Wai Kin Sin have stated that they will step down from the Hang Seng Board following the AGM in May to devote more time to their own businesses. We thank them for their valuable counsel, which has helped support the long-term growth of the Bank.

The year ahead will bring new tests. We will continue to focus on the business values that have been central to Hang Seng's success since its establishment in 1933 – including financial prudence, service excellence and lasting partnerships. Such values have helped us build a trusted brand and grow from a local money changer to one of the 30 largest listed banks in the world in terms of market capitalisation.

In facing the challenges that lie ahead, our stakeholders can bank on us to uphold our core principles and stay focused on our objectives. We will work with determination, integrity and diligence to attain long-term growth.

**Raymond Ch'ien**

Chairman

Hong Kong, 2 March 2009

## CHIEF EXECUTIVE'S REPORT

Hang Seng's results for 2008 reflect the difficult operating environment, particularly in the second half of the year.

Our well-considered strategy, trusted brand and prudent approach to business helped cushion the impact of the global financial tsunami. We strengthened our balance sheet through early action to manage credit risk in customer lending and Treasury's balance sheet management portfolio, and significantly reduced equity risk through disposal of our equity portfolios. We maintained good cost control while investing in the long-term development of our business. We achieved income growth across three of our four core customer groups but profitability was affected by increased loan impairment charges and other credit risk provisions.

Personal Financial Services maintained good earnings for the first half of 2008, but recorded a 29.4 per cent decline in profit before tax to HK\$8,410 million for the year, with unfavourable investor sentiment leading to significant reductions in fee and trading income during the second half. Operating profit excluding loan impairment charges was down 30.2 per cent at HK\$8,467 million.

Supported by our diverse portfolio of products and time-to-market strength, we retained our competitive edge in wealth management, with particular progress in insurance business. Wealth management revenue increased in the first half of the year, but with the sharp downturn in financial markets in the second half growth slowed, resulting in a 37.6 per cent fall in income for the year.

Net interest income remained stable, with the success of our credit card portfolio and the careful expansion of our personal loans portfolio offsetting narrowing margins on deposits and mortgage lending. We increased our market share for credit card business in terms of the card base, spending and receivables.

Commercial Banking achieved more diversified revenue streams, with year-on-year increases in every major income category. Operating profit excluding loan impairment charges rose by 6.5 per cent to HK\$2,354 million. However, increased loan impairment provisions in the unfavourable economic environment saw profit before tax fall by 8.6 per cent to HK\$2,470 million.

Leveraging our large base of business customers, we selectively grew average customer advances by 14.5 per cent. Falling commodity prices and the slowdown in international trade led to a year-on-year decline in trade finance, while factoring advances rose. The reduction in interest rates dragged down deposit spreads, offsetting in part the 14.7 per cent increase in net interest income from advances to give an overall net interest income growth of 2 per cent.

Commercial Banking's other operating income rose by 11.8 per cent. We increased revenue from corporate wealth management by 4.5 per cent, contributing 10.4 per cent of total operating income. We improved corporate life insurance product offerings and sales training, leading to a 96.6 per cent rise in revenue.

The successful launch of express China remittance services underpinned an encouraging improvement in our outward remittance market share. Our comprehensive financial solutions for retailers helped us capture more card merchant-acquiring business, with good growth in related fee income. Our card merchant services were a continuing source of new customer acquisitions. We achieved a 5.5 per cent year-on-year increase in the number of new commercial customers.

Corporate Banking's operating profit excluding loan impairment charges rose by 36.3 per cent to HK\$815 million. Profit before tax grew by 35.8 per cent to HK\$645 million. We attained a 37.4 per cent increase in net interest income, with increases in average customer advances and deposits of 7.9 per cent and 5.4 per cent respectively. Having exercised restraint in asset growth leading up to 2008, Corporate Banking was able to support customers with new or renewed facilities at good risk-adjusted returns. Net interest income from advances was up 45.3 per cent.

Treasury recorded a 98 per cent rise in operating profit excluding credit risk provisions to HK\$3,037 million. Operating profit increased by 8.3 per cent to HK\$1,662 million.

The balance sheet management portfolio benefited from favourable interest rate movements, with net interest income increasing by 104.4 per cent to HK\$2,682 million. Beginning in late 2007 as signs of the global financial crisis began to emerge, we took steps to reduce the credit risk of the balance sheet management portfolio. Throughout 2008, we enhanced the credit quality of the debt securities portfolio through the active disposal of some negotiable instruments. During the last quarter of 2008, we made selective investments in high-quality debt securities, most of which were triple-A rated papers. However, the growing credit crunch and deteriorating economic conditions in the second half had a negative impact on some balance sheet management portfolio investments. With reduced investor appetite for equities, we expanded trading income by successfully promoting foreign exchange-linked products and capital protected investments.

Profit before tax, including share of profits from associates, increased by 24.6 per cent to HK\$2,279 million.

Further efforts to expand the capabilities and reach of our Mainland business supported significant growth in the customer and deposit bases. Our investment in Industrial Bank continued to yield good returns.

Our Mainland subsidiary bank, Hang Seng Bank (China) Limited, extended its network to 33 outlets across 11 cities. Full-time equivalent staff increased by 32.2 per cent to 1,450. Enhanced customer relationship management helped drive the development of our wealth management business.

Hang Seng China's total operating income rose by 63.7 per cent, but further investment in new outlets and staff, exchange losses on US dollar capital funds upon revaluation against the renminbi and an increase in loan impairment charges led to a drop in profit before tax.

Including our share of profit from Industrial Bank, Mainland business contributed 11.9 per cent of total profit before tax, compared with 6.5 per cent a year earlier.

In the last quarter of 2008, we completed an RMB800 million acquisition of 20 per cent of the enlarged share capital of Yantai City Commercial Bank – one of the largest city commercial banks in Shandong province. This investment has strengthened our foothold in the Mainland's rapidly developing Bohai Economic Rim region and complements our existing operations which are concentrated in the Pearl River Delta and Yangtze River Delta regions.

Following the success of our brand rejuvenation programme in 2006-07, we made more investments in brand building in 2008 to strengthen our image as a professional wealth management partner, increasing our appeal among key customer segments.

## **Financial Highlights**

Attributable profit for 2008 was down 22.7 per cent at HK\$14,099 million, due mainly to the drop in wealth management income and increase in loan impairment charges and other credit risk provisions in the second half of the year. In 2007, we recorded a dilution gain on our investment in Industrial Bank. Excluding this gain, attributable profit was down 16 per cent.

Our strong brand and wide range of products and services helped support revenue streams. Net operating income before loan impairment charges and other credit risk provisions grew by 15.1 per cent during the first half, but with the sustained decline in market conditions during the second half, was down HK\$1,719 million, or 6.9 per cent, at HK\$23,296 million for the year.

Operating profit excluding loan impairment charges and other credit risk provisions fell by 10.1 per cent to HK\$16,501 million, with solid growth in net interest income more than offset by reduced non-interest revenue, particularly from fee-generating business. The 381.9 per cent increase in loan impairment charges and other credit risk provisions to HK\$2,776 million saw operating profit fall by 22.8 per cent to HK\$13,725 million.

Profit before tax was HK\$15,878 million – a drop of 26 per cent compared with a year earlier, or 20.6 per cent excluding the 2007 dilution gain.

Net interest income increased by 10.3 per cent to HK\$16,232 million, underpinned by the 11.6 per cent rise in average customer advances, growth of lending at improved pricing and higher margins on

Treasury's balance sheet management portfolio. The 6.8 per cent rise in average customer deposits was outweighed by narrower deposit spreads. Net interest margin was up 13 basis points at 2.36 per cent. Net interest spread rose by 31 basis points to 2.15 per cent, benefitting from asset repricing, better Treasury portfolio yields and growth in low-cost customer deposits.

Net fee income fell by 27.8 per cent to HK\$4,969 million, due mainly to a significant drop in investment services-related income. The success of our credit card merchant-acquiring business helped drive growth of 24.4 per cent in card services revenue and we achieved solid increases in income from remittances and credit facilities. Our comprehensive wealth management offerings helped maintain investment-related growth during the first six months of the year, but with the sharp drop in investor activity during the second half, revenues from stockbroking and related services, retail investment funds and structured investment products were all down compared with 2007.

The unfavourable investment environment also affected trading income from securities, derivatives and other trading activity. With reduced customer interest in equities investments, our timely promotion of foreign-exchange linked products drove encouraging growth in related revenue. Overall, trading income fell by 13.3 per cent to HK\$1,455 million.

Wealth management income was up 2.2 per cent at HK\$3,518 million for the first half of 2008, but down 37.6 per cent at HK\$5,389 million for the year.

As economic conditions became more uncertain, our diverse wealth management portfolio and time-to-market advantage helped us rapidly shift our sales focus to more defensive products. However, the significant drop in investment activity saw investment income decline by 40.8 per cent to HK\$3,692 million. Private banking income was down 75.4 per cent.

Enhancements to retirement planning and protection products led to good growth of HK\$2,629 million, or 28 per cent, in net earned insurance premiums. We were Hong Kong's number one life insurance provider in terms of new annualised regular premiums for the first three quarters of 2008 and increased our market share.

We took early steps to defend the life insurance funds portfolio against the market downturn. In the second quarter, we replaced a substantial proportion of equities investments under the portfolio with debt securities investments, resulting in a 47.5 per cent year-on-year rise in net interest income and a significantly reduced loss on investment returns of HK\$35 million during the second half compared with the HK\$1,030 million loss in the first six months of the year. Overall, insurance income was down 29.4 per cent at HK\$1,697 million, due mainly to the HK\$1,065 million loss on investment returns.

Operating expenses increased by HK\$145 million, or 2.2 per cent, reflecting investment in future business growth on the Mainland. Excluding our Mainland business, operating costs fell by 2.7 per cent, with traditional cost discipline and lower performance-related pay expenses outweighing rising salary and rental costs.

At the beginning of 2008, we switched from the 'standardised approach' to the 'foundation internal ratings-based approach' for calculating capital ratios under Basel II. As at 31 December 2008, our capital adequacy ratio and core capital ratio were 12.5 per cent and 9.5 per cent respectively.

We continue to command high credit ratings. Our B+ financial strength rating and B+ fundamental strength rating from Moody's Investors Service and Standard & Poor's respectively are the highest such ratings for Hong Kong banks. Hang Seng China has been assigned local and foreign currency long-term counterparty credit ratings of A+ and local and foreign currency short-term counterparty credit ratings of A-1 by Standard & Poor's, and long-term domestic and foreign currency deposit ratings of A1 and short-term domestic and foreign currency deposit ratings of Prime-1 by Moody's.

As at 31 December 2008, shareholders' funds (excluding proposed dividends) were HK\$45,890 million, a 9.5 per cent decline compared with a year earlier, due largely to the fair-value changes in available-for-sale investments.

Total assets grew by 2.2 per cent to HK\$762.2 billion. At year-end, the advances-to-deposits ratio was 54.4 per cent, compared with 52.2 per cent a year earlier.

Gross advances to customers grew by 7 per cent to HK\$331.2 billion.

With export activity and commodity prices declining, trade finance fell by 17.2 per cent. Factoring advances increased by 2.8 per cent. We maintained our consistently prudent lending policies in support of corporate and commercial customers.

Lending to individuals (excluding Government Home Ownership Scheme mortgages) rose by 3.6 per cent. Credit card advances were up 13.1 per cent on the back of good increases in the card base and spending. Residential mortgage lending remained competitive, but our e-Mortgage services helped us record growth of 4.4 per cent. We increased our personal loan market share to 8.2 per cent.

Loans for use outside Hong Kong rose by 10.2 per cent to HK\$35.8 billion. Mainland lending increased by 3.7 per cent to HK\$26.9 billion.

As operating conditions for businesses become increasingly difficult, loan impairment charges rose. As at 31 December 2008, total loan impairment allowances as a percentage of gross advances to customers was 0.61 per cent, compared with 0.34 per cent a year earlier. Gross impaired advances as a percentage of gross advances to customers was up 0.6 percentage points at 1 per cent.

Customer deposits grew by 2.3 per cent to HK\$604.5 billion. Time deposits, certificates of deposit and other debt securities in issue all fell, but these drops were outweighed by increased savings account deposits and the 91.8 per cent growth in deposits from Hang Seng China on the back of a rise in the number of accounts and enhanced renminbi services.

## **Branding**

In the increasingly difficult operating environment, our well-respected brand helped differentiate us from our peers.

In 2006, we launched an integrated brand rejuvenation programme to further strengthen customer loyalty and increase Hang Seng brand preference among key market segments.

Testimonial-based TV commercials featuring true stories of well-known Hang Seng customers focused on the areas of small and medium-sized enterprise (SME) services, investment, insurance, e-Banking, credit cards, Commercial Banking and Prestige Banking. These commercials received favourable external feedback, especially with regard to our professional and trustworthy image.

The launch of innovative products such as the Hang Seng Islamic China Index Fund and convenient new services including Mobile Trading, e-Priority Booking and Green Banking have enhanced our wealth management image and reinforced our progressive approach to business.

We developed a new branch design with a vibrant green as our new corporate colour. The bulkheads at all branches now reflect the new look, and recently opened and refurbished branches have adopted the design throughout their premises. Along with pop concert and television drama sponsorship, the dynamic image conveyed by the new design has helped us rejuvenate our image and build stronger connections with young people.

Our research shows that these efforts over the past few years have successfully improved our brand preference and recommendation scores, especially among young and affluent customer segments. We are now one of the top two bank brands in Hong Kong, with one-third of retail banking customers naming Hang Seng as their most preferred bank and year-on-year growth of 13 per cent in the number of our retail banking customers willing to recommend us to others. We are also among the top two banks for brand recommendation in the SME segment. Over 40 per cent of our SME customers would recommend us to others, and, beginning in 2006, we have won the SME's Best Partner Award from the Hong Kong Chamber of Small and Medium Business for three consecutive years.

## **Rising To The Challenge**

The global financial crisis posed new challenges in 2008 and the year ahead is likely to be equally demanding. The global recession may lead to further deterioration in our operating environment. Hong Kong's economy is expected to continue to contract in 2009.

Our sound financial fundamentals, strong franchise and culture of service excellence are important competitive advantages.

Our trusted brand has also proved a valuable tool in deepening existing customer relationships and establishing new ones. We will continue to leverage our strong reputation and track record to increase our market share in core business areas and key customer segments, including through the launch of more Hang Seng-branded products.

Aided by our diverse portfolio of investment and insurance offerings and time-to-market capability, we will remain proactive in providing tailor-made wealth management solutions in changing economic conditions.

Our Commercial Banking teams in Hong Kong, the Mainland and Macau will continue to work together to offer our business customers the advantage of efficient one-stop financial services. We will further grow our corporate wealth management capabilities.

In the tighter credit environment, we are working to support our SME customers. We have approved over 1,000 applications totalling close to HK\$3 billion under the revised SME Loan Guarantee Scheme and Special Loan Guarantee Scheme launched by the Hong Kong government.

Treasury will actively manage its well-diversified portfolio and continue to prudently grow non-interest income by offering customer-driven products and efficient service delivery.

Additional outlet openings and strengthened relationship management will help Hang Seng China expand its customer and deposit bases to provide a springboard for future growth. We will build on the synergies created by our strategic partnerships.

We will continue to capitalise on the good progress made under our brand rejuvenation programme.

This will be my last annual report for Hang Seng as I will retire from my position as Vice-Chairman and Chief Executive following the Bank's AGM on 6 May 2009. It has been both an honour and a pleasure to serve Hang Seng since 2005. I wish to thank my fellow Directors for their support and wise counsel, and my colleagues for their hard work and dedication, which have been central to the good progress we have made in further enhancing Hang Seng's brand strength and market position. I must also convey my heartfelt appreciation to our customers and shareholders for their strong support in these endeavours.

I would like to take this opportunity to wish my successor, Mrs Margaret Leung – currently Group General Manager and Global Co-Head Commercial Banking for the HSBC Group – every success in her new role.

The past year has been a testing one. But it has also reminded us to never underestimate the positive power of prudence and working as a team.

Our customers have come to bank on our sound business judgement and passion for providing premium service. Hang Seng, in turn, continues to benefit from their loyalty and trust.

Hang Seng is committed to working with customers, business partners and local communities to tackle future challenges and capitalise on opportunities for sustainable growth.

**Raymond Or**

Vice-Chairman and Chief Executive  
Hong Kong, 2 March 2009



## **CORPORATE RESPONSIBILITY**

Sustainability is central to Hang Seng's strategy. Our operational practices and business principles emphasise long-term growth, lasting partnerships and increasing shareholder value. We use resources in a responsible manner and encourage our stakeholders to do the same. Investment in our staff reflects their status as our most valuable assets. We work to promote the development and well-being of the communities that support us.

Our efforts to fulfil our responsibilities as one of Hong Kong's largest corporate citizens have earned us widespread recognition. We have been a constituent member of the FTSE4Good Global Index – which tracks companies that meet international standards of corporate responsibility – since 2001. We were the first local financial institution in Hong Kong to attain ISO 14001 accreditation, which now covers 90 per cent of our office premises. Our 'Go Green' environmental programme received a Silver Award at the 2008 China Golden Awards for Excellence in Public Relations.

We produce an annual online corporate responsibility report that gives more detail on our approach to sustainability and relationships with stakeholders, and acts as an important benchmark for monitoring our progress.

### **Working For A Better Tomorrow**

We participate in a wide range of community development initiatives, focusing particularly on the environment, young people, social welfare and sports. In the past 10 years, we have provided about HK\$182 million in donations and sponsorships, including more than HK\$23 million in 2008.

The global response to the snowstorms that hit mainland China's central and southern regions and the earthquake that devastated parts of Sichuan province highlights what can be achieved with a can-do spirit and a common goal. We donated a total of HK\$3 million to the relief and rehabilitation efforts through our support of the Hong Kong Red Cross and our sponsorship of the Catastrophe Management Initiative, initiated by The University of Hong Kong and Beijing Normal University, which provided a forum for national and international experts to discuss solutions to post-quake challenges.

We continued our long-standing support of The Community Chest of Hong Kong, donating HK\$3.3 million to aid its 144 beneficiary organisations. This included HK\$1 million raised as part of our 75<sup>th</sup> Anniversary celebrations in March and record-breaking staff donations of nearly HK\$474,000 for Dress Special Day. The Bank matched staff contributions dollar-for-dollar for a total donation of close to HK\$948,000. Over the past 20 years, we have given more than HK\$43 million to the Chest. We also provide expertise, with several members of senior management serving on Chest committees.

This commitment to community service is visible at all levels of our organisation. In 2008, our Staff Volunteer Team spent about 11,000 hours participating in social welfare and environmental activities – including hosting Christmas parties and table tennis fun days for disadvantaged children, arranging home visits and a festive dinner for the elderly, and working with green groups to promote the conservation of natural resources. The team also gave over 380 man-hours to help paint a mural at Queen Mary Hospital in Hong Kong under the Mural Painting Programme organised by Art in Hospital.

Our e-Donations service helped customers give over HK\$6 million to charitable causes in 2008.

### ***Investing In Hong Kong's Future***

Our strategy for long-term development includes investing in tomorrow's decision-makers and helping them build sound values for the future. Since 1995, we have allocated about HK\$54 million to various scholarship schemes, benefitting over 1,400 students from Hong Kong and the Mainland.

To encourage good citizenship among young people, we launched the Community Service Scholarship Scheme in 2008, which rewards outstanding undergraduate students from 10 local tertiary institutions who contribute to society through voluntary service.

A record 130,000 individuals took part in the 'Hang Seng Bank – Help the Police Fight Youth Crime Competition', which we sponsored for the eighth consecutive time. And in partnership with the

Independent Commission Against Corruption, we enabled over 500 youngsters to explore the importance of positive values beyond wealth through the medium of film.

Our sponsorship of the Ming Pao Student Reporter Programme and the Inter Post-Secondary College Debate Competition enables students to learn about the power of strong communication skills in facilitating the exchange of ideas and fostering critical thinking.

To celebrate the diversity of talent that helps create a strong society, in September we gave children with specific learning disabilities or attention deficit disorder the chance to showcase their creative and artistic skills at an 'Inspiration Day' organised with The Pathways Foundation.

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

Participation in sports provides valuable lessons in setting personal goals, working to exceed expectations, and the benefits of teamwork, perseverance and determination.

In 2008, we shared in the pride of China's achievement in hosting a spectacular Olympic Games. Through the Hang Seng Athlete Incentive Awards Scheme, organised by the Hong Kong Sports Institute, we were honoured to award over HK\$1.4 million to Hong Kong Olympic and Paralympic athletes who displayed courage and commitment to attain sporting excellence. In the past eight years, the Scheme has given about HK\$8.6 million to local sports heroes who set positive examples and inspire young people with outstanding performances at major national and international games.

Since 1991, we have provided over HK\$25 million to support the development of table tennis in Hong Kong. The Hang Seng Table Tennis Academy we established in 2001 has nurtured a large pool of young talent and provided more than 130,000 people with the chance to improve their sporting skills through around 2,650 courses, workshops and events.

### **Caring For The Environment**

Protection of the natural environment should be of concern to everyone. We are working to reduce the negative environmental impacts of our business, increase our participation in activities that have beneficial effects, and be a positive influence on the environmental practices of our stakeholders. This focus has helped us remain carbon neutral since 2007.

Our Environmental Management Committee implements and monitors our environmental management system, particularly compliance with ISO 14001 requirements. We promote green messages through internal communication channels and conservation-focused activities for staff and their families.

We continue with efforts to reduce the consumption of resources by raising awareness, replacing less efficient systems with more efficient ones, reusing items whenever it is possible and making efforts to recycle when it is not.

In 2008, we replaced the air-cooled chillers in our headquarters building with water-cooled ones. This will cut our electricity consumption by about 1.9 million kWh per year, resulting in an annual saving of HK\$2.4 million in energy costs and reducing our carbon dioxide emissions by more than 1,700 tons.

We have achieved recycling rates of 90 per cent for toner and printer ink cartridges and 98 per cent for obsolete computer equipment. Our electronic document initiatives are saving about 10 million sheets of paper a year.

Organised in partnership with the Federation of Hong Kong Industries, the Hang Seng Bank Pearl River Delta Awards recognise manufacturing companies in southern China that are taking steps to enhance their environmental performance. In June 2008, we awarded a total of HK\$330,000 to 12 winners for their efforts to reduce their ecological footprint.

For a second consecutive year, we helped protect the environment while improving lives on the Mainland by sponsoring The Conservancy Association's biogas energy project. In December, Bank volunteers traveled to a village in Yunnan province to help build 300 biogas toilets that will provide about 1,200 villagers with renewable energy. In addition to reducing annual firewood needs and carbon dioxide emissions by 750 tons and 3,750 tons respectively, the project will also help slow the

pace of soil erosion resulting from deforestation and produce a residue that can be used as a natural fertiliser. This project was recognised as a Clinton Global Initiative (CGI) corporate citizenship commitment at the 2008 CGI Asia meeting held in Hong Kong.

We also partnered with The Conservancy Association to organise a 'Tree Lovers Day' at Kowloon Park in November. Attended by over 2,000 people, the event was designed to explain the importance of tree conservation to the public.

We are involved in the Eco-Explorer programme, organised by Friends of the Earth (HK), which offers school-age children the opportunity to investigate the natural world through on-site observation. We are also helping raise environmental awareness at nine Hong Kong tertiary education institutions through workshops, training and other green activities under our HK\$14 million 'Hang Seng – Green Bank' initiative.

Environmental and social considerations form an important part of our financing decisions. We encourage responsible business in ecologically sensitive industries through sector-specific lending policies and incorporate environmental factors in our credit risk assessments. We support the Equator Principles, which are used to manage environmental and social risks in project financing.

Our tender and agreement documents require suppliers to establish an environmental policy and our evaluation of any potential new supplier includes consideration of its environmental performance.

We engage with environmental organisations and our suppliers to help conserve biodiversity through sustainable sourcing. We stopped serving shark's fin at Hang Seng functions in 2003 and have since extended this ban to include endangered reef species and black moss. We comply with the guidelines set out in WWF Hong Kong's *Seafood Guide*.

We advocate continual learning through dialogue with stakeholders and industry peers. We exchange information and ideas on critical sustainability issues through active participation in a variety of professional groups, including the Carbon Disclosure Project and the Climate Change Business Forum.

We also lend our support to events designed to raise awareness of issues that affect the well-being of our community. In June, we participated in the Lights Out campaign organised by Friends of the Earth (HK).

## Environmental Performance

	2008	2007	2006	2005	2004	2008 vs 2007	2008 vs 2006
Greenhouse gas emissions per person* (tons CO <sub>2</sub> /FTE)	<b>3.28</b>	3.30	3.30	3.61	3.62	-0.6%	-0.6%
Greenhouse gas emissions per m <sup>2</sup> * (tons CO <sub>2</sub> /m <sup>2</sup> )	<b>0.20</b>	0.20	0.20	0.21	0.21	0%	0%
Greenhouse gas emissions* (kilotons CO <sub>2</sub> )	<b>27.4</b>	26.7	25.3	26.4	26.2	2.6%	8.3%
Electricity consumption (GWh)	<b>38.1</b>	35.9	34.1	33.3	32.9	6.1%	11.7%
Gas consumption (GWh)	<b>0.42</b>	0.70	0.82	0.86	0.86	-40%	-48.8%
Water consumption (000 m <sup>3</sup> )	<b>50.8</b>	54.1	70.4	91.1	100.6	-6.1%	-27.8%
IT/electrical waste recycled (tons)	<b>64.9</b>	59.0	41.7	38.8	37.0	10.1%	55.6%

*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 were carbon neutral in 2008

## **CORPORATE GOVERNANCE AND OTHER INFORMATION**

Hang Seng is committed to high standards of corporate governance. 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 all the code provisions 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.

### **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 :

- annual plans and performance targets;
- specified senior appointments;
- acquisitions and disposals above predetermined thresholds; and
- any substantial change in balance sheet management policy.

#### **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 of the Bank is an executive Director who exercises all the powers, authorities and discretions of the Executive Committee as may be delegated to him in respect of the Bank and its subsidiaries.

#### **Board Composition**

As at the date of this Annual Report, the Board comprises 16 Directors, of whom 3 are executive Directors and 13 are non-executive Directors. Of the 13 non-executive Directors, 9 are independent non-executive Directors. All the independent non-executive Directors meet the guidelines for assessment of independence as set out in Rule 3.13 of the Listing Rules. There is a strong independent element on the Board, which can effectively exercise independent judgement.

Members of the Board of the Bank, 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 at the beginning of the year. In addition, notice of meetings will be given to all Directors prior to each Board meeting, normally at least 14 days in advance.

Other than regular Board meetings, in 2008, the Chairman also met with non-executive Directors, including independent non-executive Directors, without the presence of executive Directors, to discuss general issues including board governance and risk management.

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 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 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. Retiring Directors shall be eligible for re-election at the Annual General Meeting 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, the opinions of the existing Directors (including the independent non-executive Directors) are sought. 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 scheduled Annual General Meeting after their appointments have become effective.

There was no change to the composition of the Board during the year 2008.

## 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 set out in the Model Code for Securities Transactions by Directors of Listed Issuers (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 interests in Group securities, including HSBC Holdings plc and the Bank, held by the Directors as at 31 December 2008 are disclosed in the Directors' Report set out in this Annual Report.

## Board Members' Attendance

Name	Number of meetings attended during 2008
Dr Raymond K F Ch'ien* ( <i>Chairman</i> )	7 out of 7
Mr Raymond C F Or ( <i>Vice-Chairman and Chief Executive</i> )	7 out of 7
Mr Edgar D Ancona <sup>#</sup>	7 out of 7
Mr John C C Chan*	5 out of 7
Mr Patrick K W Chan ( <i>Executive Director and Chief Financial Officer</i> )	7 out of 7
Dr Y T Cheng*	7 out of 7
Dr Marvin K T Cheung*	5 out of 7
Mr Alexander A Flockhart <sup>#</sup>	4 out of 7
Mr Jenkin Hui*	7 out of 7
Mr Peter T C Lee*	7 out of 7
Dr Eric K C Li*	7 out of 7
Dr Vincent H S Lo <sup>#</sup>	4 out of 7
Mr Joseph C Y Poon ( <i>Managing Director and Deputy Chief Executive</i> )	7 out of 7
Dr David W K Sin*	7 out of 7

Mr Richard Y S Tang*	7 out of 7
Mr Peter T S Wong#	6 out of 7

\* Independent non-executive Directors

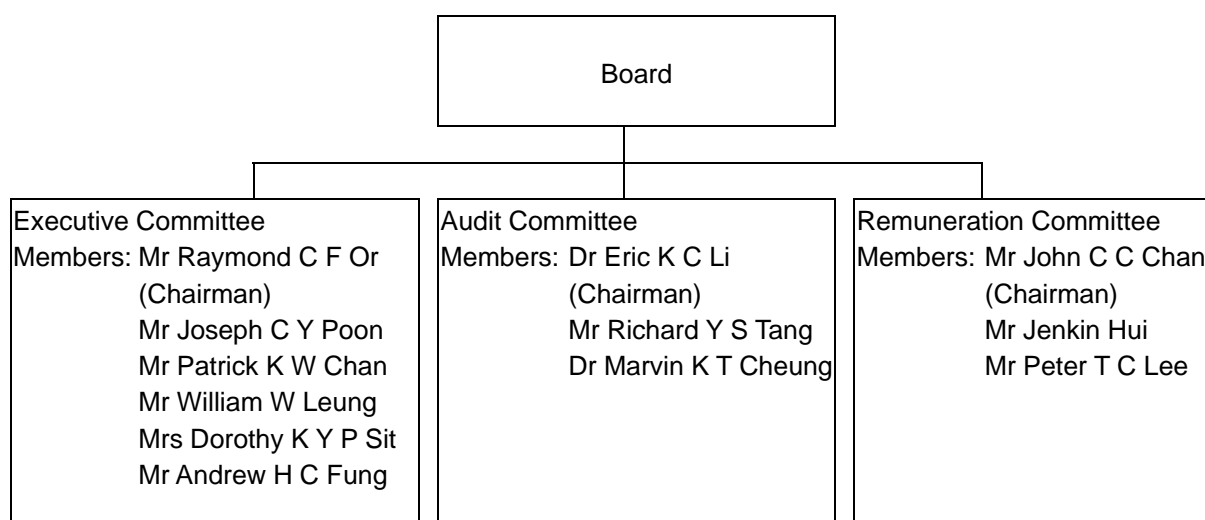
# Non-executive Directors

## DELEGATION BY THE BOARD

### Board Committees

The Board has set up 3 committees: the Executive Committee, the Audit Committee and the Remuneration Committee.

Each of these committees has specific written terms of reference which deal clearly with their authority and duties. 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 of 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.

To further enhance the Bank's risk management framework and in line with best practices, the Bank set up a Risk Management Committee in July 2008 to centralise the risk management oversight function of the Bank. The 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 8 types of risks stipulated in the Supervisory Policy Manual of HKMA, namely, credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal risk, reputation risk and strategic risk. It is also responsible for approval of all risk management related policies.

The **Audit Committee** meets regularly, normally at least 4 times a year, with the senior financial, internal audit and compliance executives 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 2008		
	Executive Committee	Audit Committee	Remuneration Committee
Mr Raymond C F Or	14 out of 14	-	-
Mr John C C Chan*	-	-	2 out of 2
Mr Patrick K W Chan	13 out of 14	-	-
Dr Marvin K T Cheung*	-	5 out of 5	-
Mr Jenkin Hui*	-	-	2 out of 2
Mr Peter T C Lee*	-	-	2 out of 2
Dr Eric K C Li*	-	5 out of 5	-
Mr Joseph C Y Poon	13 out of 14	-	-
Mr Richard Y S Tang*	-	5 out of 5	-
Mr William W Leung <sup>Ø</sup>	13 out of 14	-	-
Mrs Dorothy K Y P Sit <sup>Ø</sup>	12 out of 14	-	-
Mr Andrew H C Fung <sup>Ø</sup> (Note)	12 out of 12	-	-

\* Independent non-executive Directors

<sup>Ø</sup> General Managers

(Note: Mr Andrew H C Fung was appointed a member of the Executive Committee with effect from 19 February 2008.)



## REMUNERATION OF DIRECTORS AND SENIOR MANAGEMENT

### The Level And Make-up Of Remuneration

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

The Remuneration Committee held 2 meetings in 2008. The major work performed by the Committee during 2008 included:

- reviewing the fees payable to the Directors and the members of the Board Committees of the Bank and its subsidiaries;
- reviewing the remuneration of the executive Directors and senior management of the Bank and the Directors of the Bank's subsidiaries;
- reviewing the proposed bonus pool under the Variable Incentive Scheme of the Bank;
- determining the remuneration packages of 2 newly appointed senior executives of the Bank and the fees payable to Audit Committee members of the Bank's insurance subsidiaries; and
- reviewing the pay review proposal.

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, including GDP growth and local inflation rates;
- 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 scale of Director's fees, and additional fees for membership on the Audit Committee and Remuneration Committee, is 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 the executive Directors of the Bank (including the Vice-Chairman) commencing from 1 January 2008.

Information relating to the remuneration of each Director for 2008 is set out in Note 19 to the Bank's 2008 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 3 to 5 years. The Bank's Strategic Plan for 2008 to 2012 was reviewed by the Bank's Board in January 2008.

The annual and interim results of the Bank are announced in a timely manner within the limits of 3 months and 2 months respectively after the end of the relevant periods.

The Directors acknowledge their responsibility for preparing the accounts of the Bank. As at 31 December 2008, 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 2008 Financial Statements.

### **Internal Controls**

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

The Directors are 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 responsibility, 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 Board will also approve risk management policies and major risk control limits.

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" section under the Bank's 2008 Annual Report, and in Note 62 to the Bank's 2008 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 2008 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 5 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**

Internal audit 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 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 head of internal audit of the Bank 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 2008, fees paid to the Bank's external auditors for audit services totalled HK\$12.8 million, compared with HK\$11.8 million in 2007. For non-audit services, the fees paid amounted to HK\$6.5 million, compared with HK\$6.6 million in 2007. 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	6.2
Tax services	0.3
	<hr/>
	6.5

## **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 5 meetings in 2008. The major work performed by the Committee during 2008 included:

- reviewing the Directors' Report and full-year financial statements for the year ended 31 December 2007 and the annual results announcement;
- reviewing the interim financial statements for the six months ended 30 June 2008 and the interim results announcement;
- reviewing the recently issued accounting standards, and the progress of implementation in relation to the Sarbanes-Oxley Act and Basel II;
- reviewing the establishment of an audit committee of Hang Seng Insurance Company Limited ("HSIC"), a wholly-owned subsidiary of the Bank;
- reviewing the internal audit plan for 2009;
- reviewing essential matters or high-level reports relating to financial control, internal audit, credit and compliance, and the system of internal control, and discussing the same with the Management;
- reviewing risk-related matters;
- monitoring the staffing and resources of the Bank's internal audit function;
- reviewing the oversight and monitoring of accounting risk of the Bank;
- reviewing the economic valuation models for the Bank's balance sheet management portfolio;
- reviewing the IT governance and risk control of the Bank; and
- exercising oversight over the audit committees of the Bank's principal subsidiaries.

The Audit Committee meets with the Bank's external auditors on a regular basis.

## **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 2 results announcements, a total of 98 meetings with 246 analysts and fund managers from 108 companies were held in 2008. The Bank's Chief Financial Officer made presentations at major investor forums held in Hong Kong. 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, Chairman of the Audit Committee 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 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 Thursday, 24 April 2008 at 3:30 pm at the Penthouse of Hang Seng Bank Headquarters, 83 Des Voeux Road Central, Level 24, 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 Wednesday, 6 May 2009, the notice of which will be sent to shareholders at least 20 clear business days before the 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 2009.

## **OTHER INFORMATION**

The Annual and Interim Reports contain comprehensive information on business strategies and developments. Discussions and analyses of the Bank's performance during 2008 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 2008 Financial Statements. These transactions include those that the Bank has entered into 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 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 2008, the Bank's share of the costs include HK\$208 million for system development services, HK\$161 million for data processing, and HK\$48 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\$63 million and HK\$38 million respectively in 2008. 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 whom management fee rebates were made. The rebate for 2008 amounted to HK\$102 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 constitute connected transactions under the Listing Rules, they also comply 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 2008: HK\$519 million) as contracts of significance for 2008.

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

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

- (a) On 22 June 2007, Hang Seng Life Limited ("HSL") entered into a new management services agreement ("New Management Services Agreement") with HSBC Life (International) Limited ("INHK"), a wholly-owned subsidiary of HSBC Insurance (Asia-Pacific) Holdings Limited which is an indirect wholly-owned subsidiary of HSBC Holdings plc ("HBSC"). Pursuant to the New 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 provide the management services to HSL for a term of three years.

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.

The New Management Services Agreement also provides that HSLI may assign to one or more of the wholly-owned subsidiaries of the Bank the benefits of and interests and rights in or arising under the New Management Services Agreement and may elect to have one or more such subsidiary to receive and pay for the management services or perform any of its duties or obligations under the New Management Services Agreement without obtaining the prior consent of INHK.

- (b) On 22 June 2007, HSLI also entered into a new investment management agreement (“New Investment Management Agreement”) with HSBC Investments (Hong Kong) Limited (“ISHK”), a wholly-owned subsidiary of HSBC, pursuant to which ISHK will continue to act as investment manager in respect of certain of HSLI’s assets held from time to time to maintain business continuity of HSLI. ISHK will provide investment management services to HSLI for a term of three years.

HSLI 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.

The New Investment Management Agreement also provides that HSLI may assign to one or more of the wholly-owned subsidiaries of the Bank the benefits of and interests and rights in or arising under the New Investment Management Agreement and may elect to have one or more such subsidiary to receive and pay for the services or perform any of its duties or obligations under the New Investment Management Agreement without obtaining the prior consent of ISHK.

HSLI has become a wholly-owned subsidiary of HSIC, a wholly-owned subsidiary of the Bank, since September 2007. INHK and ISHK 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. Therefore, the New Management Services Agreement and the New Investment Management Agreement (collectively “the New Agreements”) constituted continuing connected transactions for the Bank under the Listing Rules. Details of the New Management Services Agreement and the New Investment Management Agreement were announced by the Bank on 22 June 2007.

As part of the plan of the Bank to rationalize 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 New Management Services Agreement and the New Investment Management Agreement.

For the year ended 31 December 2008, the aggregate amounts paid under the New Management Services Agreement and the New Investment Management Agreement were HK\$108.7 million and HK\$50.2 million respectively.

In respect of the above continuing connected transactions (the “Continuing Connected Transactions”), all the independent non-executive Directors of the Bank have reviewed the transactions and confirmed that the 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 New 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 Continuing Connected Transactions:

- (1) have been approved by the Boards of Directors of the Bank, HSLI and HSIC;
- (2) have agreements in place governing the Continuing Connected Transactions;
- (3) have been entered into in accordance with the pricing terms of the relevant agreements governing the Continuing Connected Transactions 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 Continuing Connected 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 2008, the Bank's total headcount was 9,764, reflecting an increase of 574, or 6.2 per cent, compared with a year earlier. The total comprised 1,083 executives, 3,811 staff officers and 4,870 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 competitive market pressures.

Under appropriate circumstances, performance-related variable pay is provided as an incentive for staff. In 2008, incentive payments were made to staff members who had chosen to join the Bank's New Annual Pay Scheme with variable bonus under performance-based remuneration strategy.

Since 1999, 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 HSBC Group shares at a discounted price after a specified period. For Sharesave 2008, 3,458 staff members had subscribed to the plan.

Other incentive awards were also made. More than 1,800 staff with outstanding performance and/or good potential were rewarded with HSBC Group shares or cash award in 2008.

### ***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 second bankwide Global People Survey was conducted in July 2008 as a continuous initiative to measure staff engagement level. The results in September 2008 were very positive and communication sessions to staff were organised to disseminate the survey results.

### ***Staff Development***

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

New staff joining the Bank attend an induction programme that provides them with a better understanding of the history, culture and values of the Bank. Continuous educational development is provided to staff through the Bank's Learning Resource Centre, multi-media programmes, an intranet site, online quizzes, classroom instruction, seminars and branch online videos. Staff members are also encouraged to pursue professional or academic qualifications through the Bank's Education and Professional Qualification Award System.

The average number of training days per staff member in 2008 was 6 days.

### ***Recruitment And Retention***

Vigorous external recruitment activities continued in the first half year of 2008, especially for front-line sales positions and experienced professionals and specialists. Special reviews were done on job families with high turnover and vulnerable individuals and retention programmes were developed. Following the financial tsunami in the second half of year 2008, the labour market became less active and thus staff turnover of the Bank was stabilized. In view of the difficult operating environment, the Bank had responded quickly to control headcount and staff cost growth via natural attrition, staff-on-loan and staff redeployment. External recruitment was restricted only to cases justified by

business needs.

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. Trainee programmes were continued for jobs in selected functional areas 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 (the "Code") contained in the Staff Handbook. Following the relevant regulatory guidelines and other industry best practices, the Code sets out ethical standards and values to which 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.

### ***Health And Safety***

The Bank recognises the need for effective management of health and safety in order to provide a safe working environment. The Bank focuses on identifying health, safety and fire risks in advance, taking any measures necessary to remove, reduce or control material risks of fires and of accidents or injuries to employees and visitors.

The Bank maintained a Communicable Diseases Plan. This sets out the key issues to be addressed and the responses to be taken in the event of a similar occurrence involving a serious communicable disease. To get the Bank prepared for the outbreak of avian influenza, an Avian Influenza Contingency Manual was prepared jointly by various divisions with reference to the SARS experience, and Tamiflu was stockpiled for 100% of the Bank staff in case of an outbreak of avian influenza. Staff have been made aware through various channels of the importance of personal hygiene and health, and informed of the contingency measures to adopt should there be an outbreak of avian influenza.

To promote the importance of work life balance and foster a happy workplace culture, a Staff Recreation Centre was maintained at Mega Site to provide staff members with various facilities for physical exercises and leisure activities.



# MANAGEMENT DISCUSSION AND ANALYSIS

## BUSINESS IN HONG KONG

In an unfavourable operating environment, particularly in the latter half of the year, Hang Seng's diverse portfolio of products and services helped us adapt to the changing market conditions. Our strong brand proved an important point of differentiation from our peers.

This helped sustain profits growth during the first half of the year and buffered our business against the effects of the financial storm during the second half.

Active management of our customer relationships and a comprehensive credit risk assessment system enabled us to identify good opportunities to expand quality lending during the year. Gross advances to customers increased by 7 per cent to HK\$331.2 billion.

Customer deposits, including certificates of deposit and other debt securities in issue, grew by 2.3 per cent to HK\$604.5 billion, due mainly to increases in Hong Kong dollar and US dollar savings accounts as customers took a more cautious approach to investment.

### Personal Financial Services

Personal Financial Services' profit before tax fell by 29.4 per cent to HK\$8,410 million, due largely to the drop in wealth management income during the volatile market conditions of the second half. Operating profit excluding loan impairment charges was down 30.2 per cent at HK\$8,467 million.

Net interest income remained stable at HK\$8,700 million, with increases in credit card business and personal loans outweighing narrowing spreads on deposits and mortgage loans.

Non-interest income declined by 43.4 per cent, with negative investor sentiment resulting in a significant slowing of fee-earning investment business.

Our wealth management business maintained earnings growth during the first half of the year, recording a 2.2 per cent increase to reach HK\$3,518 million. Good growth in new life insurance business, a rapid shift in portfolio focus to more defensive investment products, and increased foreign exchange trading helped cushion the impact of economic conditions in the second half, but wealth management income for the year fell by 37.6 per cent to HK\$5,389 million.

Investment services income was down 40.8 per cent, reflecting reduced investor activity and the downtrend in equities values. Our leadership position in the life insurance market supported a HK\$2,629 million increase in net earned insurance premiums. Strong management of the life insurance funds portfolio underpinned the 47.5 per cent increase in net interest income for the year and helped contain the loss on investment returns at HK\$35 million in the second half, compared with the HK\$1,030 million loss in the first half. Overall, insurance income fell by 29.4 per cent to HK\$1,697 million.

We launched a Green Banking account for students and a new credit card that are helping increase our appeal among key customer segments.

### *Investment Services*

With the deterioration in equity markets during 2008, we leveraged our diverse wealth management portfolio and time-to-market advantage to meet increased demand for more conservative investment instruments. We launched three new types of 100 per cent capital protected structured products and six new capital guaranteed funds.

Our trusted brand and reputation for the well-considered development and selection of products for customers emerged as important competitive advantages. We attracted new customers in the volatile market conditions, with the number of customer investment accounts increasing by 5 per cent year on year, placing us in a good position to capitalise on future investment activity once investor confidence returns.

As customers turned away from equities investments, a series of successful initiatives to promote foreign exchange and gold margin trading services resulted in a 4.4 per cent increase in related revenue and a 7.4 per cent rise in the number of margin trading accounts.

Hang Seng brand strength was further reinforced with performance awards for three of our retail investment funds at the Lipper Fund Awards 2008.

We also competed on service delivery. We enhanced and expanded service channels, increased trading efficiency and streamlined subscription processes, making it easier for customers to grasp investment opportunities in a convenient and timely manner.

These developments helped support investment services earnings growth during the first half, but were outweighed by the sharp downturn in investment sentiment in the second half. Income from securities broking and related services fell by 31.5 per cent compared with 2007 to HK\$1,359 million. Revenue from investment funds dropped by 35.3 per cent to HK\$1,084 million and turnover was down 69.6 per cent. Income from structured products followed the same trend, declining by 40.9 per cent to HK\$882 million.

Funds under management (excluding private banking) dipped to HK\$51.5 billion – down 37.3 per cent compared with a year earlier – due mainly to a drop in the market value of the funds.

Private banking income fell by 75.4 per cent and assets under management declined by 42 per cent.

### ***Insurance***

Our comprehensive range of wealth and health insurance solutions for all life stages helped us remain Hong Kong's number one life insurance provider in terms of new annualised regular premiums for the first three quarters of the year and increase our market share.

We further refined our flagship insurance product – the Income Select Life Insurance Plan – to offer enhanced protection and increased income payment options. A market survey on financial preparation for retirement and a series of marketing campaigns increased customer awareness of our retirement planning proposition.

We took successful steps to improve our market penetration by positioning our whole-of-life insurance solutions as being for families as well as individuals, making better use of our multi-channel marketing and distribution network, and strengthening cross-referral mechanisms to reach new customers. As a result, net earned insurance premiums rose by 28 per cent to HK\$12,023 million.

Our website remained an important source of business for sales of enhanced personal insurance products, including those covering travel, home contents, personal accident and domestic helpers. New annualised insurance premiums from e-channels grew by 32 per cent compared with 2007.

### ***Consumer Lending***

Excluding the fall in Government Home Ownership Scheme mortgages, lending to individuals increased by 3.6 per cent.

A series of strategic card acquisition and utilisation campaigns helped us grow our market share for credit cards and underpinned the 13.4 per cent increase in the card base, 13.1 per cent rise in card advances and 15.9 per cent increase in card spending.

In personal loans, we achieved solid year-on-year growth of 18.9 per cent to HK\$3.3 billion and increased our market share to 8.2 per cent.

In a competitive operating environment, premium services such as our e-Mortgage proposition and dedicated mortgage consultants supported a 4.4 per cent increase in residential mortgage lending to individuals. Despite the slowdown in mortgage business during the second half, we maintained our market share.

With an eye on narrowing mortgage margins, we moved forward with diversifying our secured lending business, focusing on loan quality and profitability. Launched in October 2008, our Asset Link Secured Overdraft accepts a wide range of assets for pledge and has been well received.

## Commercial Banking

Against the backdrop of the challenging business environment, Commercial Banking performed well to achieve a 6.5 per cent increase in operating profit excluding loan impairment charges to reach HK\$2,354 million. Profit before tax fell by 8.6 per cent to HK\$2,470 million, affected by a HK\$688 million increase in loan impairment charges in the deteriorating economic conditions.

Net interest income rose by 2 per cent. Average customer advances grew by 14.5 per cent and the tighter credit environment underpinned an upward trend in pricing on new and renewed lending. Trade finance fell by 15.3 per cent on the back of declining export activity and commodities prices. Factoring advances were up 2.8 per cent. Lower interest rates narrowed spreads on deposits.

Supported by strong relationships with customers, we expanded our corporate wealth management business, which recorded a 4.5 per cent increase in income. Steps to expand and refine product offerings helped drive a 96.6 per cent rise in revenue from corporate life insurance.

We continued to promote our comprehensive financial solutions for retailers, achieving a 27.2 per cent rise in fee income from card-merchant acquiring business and helping us record a 5.5 per cent year-on-year increase in the number of new commercial customers.

We continued to enhance service delivery, extending the services of two Business Banking Centres to offer automated banking and counter services for commercial customers.

Utilising the extended network created by Hang Seng China and strategic alliances with Industrial Bank and Bank of Communications, we enjoyed success with our express China remittance service. Offering same-day remittances between Hong Kong and around 100 key cities in mainland China, this new service is helping to increase our outward remittance market share.

The close collaboration of our Commercial Banking teams in Hong Kong, the Mainland and Macau gave us a competitive advantage in capturing cross-market business flows. In September, a new branding programme was launched to establish us as a bank of choice for middle-market enterprises operating in Hong Kong and on the Mainland.

## Corporate Banking

Corporate Banking achieved a 36.3 per cent increase in operating profit excluding loan impairment charges.

Net interest income grew by 37.4 per cent. In the changing credit environment, we actively managed our loans portfolio to improve pricing. We identified new high-quality lending opportunities, leading to a 7.9 per cent increase in average customer advances. Narrower deposit spreads dampened the positive effects of the 5.4 per cent rise in average customer deposits.

Closer cross-group cooperation on corporate wealth management business supported efforts to further diversify revenue streams, with fee income up 16.5 per cent.

Profit before tax grew by HK\$170 million, or 35.8 per cent, to HK\$645 million.

## Treasury

Favourable interest rates led to improved margins on Treasury's balance sheet management portfolio, resulting in a 104.4 per cent increase in net interest income to reach HK\$2,682 million. Beginning in late 2007 as signs of the global financial crisis began to emerge, we took steps to reduce the credit risk of the balance sheet management portfolio. Throughout 2008, we enhanced the credit quality of the debt securities portfolio through the active disposal of some negotiable instruments. During the last quarter of 2008, we made selective investments in high-quality debt securities, most of which were triple-A rated papers.

With significantly reduced investor interest in equities investments, we explored new opportunities to promote foreign exchange-linked and capital protected investment products. This underpinned growth

in trading income to HK\$641 million and strengthened efforts to further diversify Treasury's income base.

The competitive operating environment saw customers focus on brand strength and service delivery as well as price. We stepped up collaboration with commercial and personal banking teams as well as IT to offer easier, more convenient trading across a wide network of channels, focusing particularly on online and mobile phone platforms.

Operating profit excluding credit risk provisions was up 98 per cent at HK\$3,037 million. Despite Treasury's prudent and proactive approach to balance sheet management, the growing credit crunch and declining economic conditions had a negative impact on certain investments under the balance sheet management portfolio, resulting in a HK\$1,375 million credit risk provision.

Treasury's profit before tax grew by 24.6 per cent to HK\$2,279 million.

## **Technology**

Technology and e-channels continue to play a critical role in improving the convenience and efficiency of our service delivery. In December 2008, online and automated machine channels accounted for 76.7 per cent of all customer transactions, up 1.5 percentage points compared with a year earlier.

At the end of 2008, we had over 870,000 Personal e-Banking customers, an increase of 14 per cent. Business e-Banking customers were up 26.5 per cent at nearly 65,000.

In rapidly changing market conditions, we used technology to offer personal customers greater flexibility over how and when they managed their finances. We improved the efficiency of our online securities trading service and streamlined processing for online securities and unit trust subscriptions under monthly investment plans. Online investment funds subscriptions as a percentage of total subscriptions was 63.1 per cent, compared with 38.4 per cent a year earlier.

With increased interest in foreign exchange and gold markets, we expanded related trading services to our mobile phone platform, helping us achieve record-high retail margin trading turnover in October.

We continued to extend our network of automated channels, implementing offsite deployment of more cash and cheque deposit machines at MTR stations and prime commercial locations.

Specifically designed for tertiary students, our Green Banking account offers convenient and secure online banking and electronic payment services.

Value-added online services – such as our e-Priority booking service that offers a fast and secure way to buy tickets for Bank-sponsored concerts and other performances – are helping to increase our appeal among younger customer segments.

As part of our commitment to sustainability, we extended our e-InvestAdvice service – under which customers can save paper resources by opting to receive electronic versions of certain bank documents – to cover foreign exchange and gold margin trading advice. Our electronic document initiatives are now saving about 10 million sheets of paper a year.

Technological enhancements helped us support business customers in the difficult economic environment through improved customer relationship management and shorter processing times for remittances and applications. We offered advice to prospective owners of small and medium-sized enterprises under a new 'Business Start-up Corner' section on our website.

In August 2008, we strengthened our corporate wealth management proposition with the introduction of online securities trading services. In December, this service accounted for 29 per cent of total securities trading turnover by business customers.

Year on year, the number of business banking transactions completed via the Internet increased by 27.8 per cent. Revenue generated from online sales and transactions by business customers increased by 28.9 per cent.

## **Hang Seng Indexes**

Wholly owned subsidiary Hang Seng Indexes Company Limited (Hang Seng Indexes) enhanced its indexing services in 2008 with the launch of new indexes to support continuing strong interest in China and further assist investors in changing market conditions.

To serve as a benchmark for comprehensive cross-market China investment, the Hang Seng China 50 Index that includes the 50 largest listed companies (in terms of market capitalisation) listed on Hong Kong and/or Mainland stock exchanges was launched in June 2008.

Launched in September, the Hang Seng Short and Leveraged Index Series comprises six short and leveraged versions of the Hang Seng Index (HSI) and Hang Seng China Enterprises Index (HSCEI) and is designed to meet the demand for indexes with investment strategies.

In October, Hang Seng Indexes introduced the Hang Seng REIT Index to track the performance of real estate investment trusts in Hong Kong.

Hang Seng Indexes now compiles 86 publicly available indexes – 43 real-time price indexes and 43 daily indexes – of which 31 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.

The total number of futures and options contracts traded on the HSI in 2008 grew by 15.9 per cent compared with 2007, while the total number of futures and options contracts traded on the HSCEI was up 30.2 per cent. At the end of December 2008, the total size of exchange-traded funds tracking the two indexes was over HK\$60 billion.

# MANAGEMENT DISCUSSION AND ANALYSIS

## BUSINESS ON THE MAINLAND

In line with our strategy for long-term growth, we continued to expand the capabilities and reach of our mainland China business in 2008.

Our Mainland subsidiary bank, Hang Seng Bank (China) Limited, invested in new outlets and staff, further leveraged Hang Seng's trusted brand and business strengths, and enhanced product offerings and service delivery through new strategic collaborations.

These developments drove a solid rise in revenue and good increases in customer accounts and deposits that will help support continued growth. The focus of Hang Seng China's expansion sees us better positioned to take advantage of future business opportunities.

Hang Seng China's total operating income rose by 63.7 per cent. A 91.8 per cent increase in deposits and efforts to improve spreads on new and renewed credit facilities underpinned the 38.7 per cent growth in net interest income.

In the declining economic conditions, we took a conservative approach to lending, focusing on quality loans that offered good potential for generating additional streams of income through cross-selling or deposits business. Customer advances were up 3.7 per cent compared with a year earlier.

Excluding foreign exchange losses on the revaluation of US dollar capital funds against the renminbi, non-interest income increased by 105.9 per cent, in part reflecting the success of our growing range of wealth management products.

However, profit before tax fell, affected by investments in expanding Hang Seng China's network and headcount, currency revaluation losses, and increased loan impairment charges in the difficult economic environment.

Returns from our investment in Industrial Bank increased. In December, we completed a deal to acquire a 20 per cent shareholding in Yantai City Commercial Bank in Shandong province.

Including our share of profits from Industrial Bank, Mainland business contributed 11.9 per cent to total profit before tax, up from 6.5 per cent a year earlier.

### Network

Hang Seng China opened two branches and eight sub-branches in 2008, bringing its network to 33 outlets across 11 cities. Our focus remains the high-potential Pearl River Delta, Yangtze River Delta and Bohai Economic Rim regions, with increasing attention to strategic cities in other areas.

Our Shenzhen branch relocated to Futian district in April, with the vacated premises in Luohu district becoming a sub-branch. The establishment in May of our first commercial sub-branch – in Chang An county in Dongguan – helped us capture new Commercial Banking business. Along with our one-stop financial services and referrals from our well-established Hong Kong operation, this supported the 20 per cent year-on-year increase in the number of Mainland commercial customers.

In November, Hang Seng China became the first foreign subsidiary bank to have a branch in Yunnan province. Located in Kunming – a primary regional gateway – the new outlet gives us early-mover advantage in providing high-quality financial services to companies and individuals in western China.

We further strengthened our presence in the Bohai Economic Rim region during the year, opening a branch in Tianjin and another sub-branch in Beijing.

To support this growth and strengthen customer relationship management, our number of full-time equivalent staff rose by 32.2 per cent to 1,450.

At the end of 2008, Hang Seng China operated 64 ATMs. Customers can also access their accounts via the more than 140 HSBC China ATMs bearing our logo. In January 2009, we joined forces with China UnionPay (CUP) to enable Hang Seng China debit cards to be used on the CUP network at

home and overseas and allow holders of other CUP-standard cards to complete transactions via Hang Seng China's ATM network.

## Services

We took steps to increase the efficiency and convenience of service delivery, including the further development of our call centre, phone banking and e-Banking services.

In Commercial Banking, we benefited from our strong relationships with customers in Hong Kong and close collaboration between Hang Seng teams across our markets of operation. We extended our commercial insurance agency service and launched forfaiting services.

We established a Mainland Trade Services Centre in Shenzhen. We will set up another centre in Shanghai later in 2009. These two centres will regionally centralise trade documents processing for our branches.

Leveraging partly on our wealth management experience and strength in Hong Kong, we launched new products to meet investor needs and risk appetite in the changing market environment, including a partially capital protected structured product and a fund-linked investment instrument under our Qualified Domestic Institutional Investor licence. We further differentiated ourselves from our competitors through the introduction of an investment consultant team.

We extended our insurance offerings through strategic agreements with several Mainland insurance companies and cooperated with estate agents and a mortgage guarantee company to strengthen our mortgage loan business.

We took steps to further penetrate the burgeoning top mass-affluent customer segment, increasing brand recognition through a series of marketing and promotional events.

These initiatives helped drive the 154 per cent increase in the number of Prestige Banking customers, providing a strong base from which to deepen relationships through increased product penetration and cross-selling. This rise in customers was an important source of deposits business, with deposits from Prestige Banking customers up by 174.3 per cent.

Our efforts to provide premium financial services have been externally recognised. Our 'Equity-Linked Partially Capital Protected Investment Product – Daily Chance' was named as one of the 10 best financial products in China by *Moneyweek* and *Shanghai Securities News*.

## Strong Alliances

In addition to organic growth, we are firmly committed to building long-term strategic partnerships that augment and complement Hang Seng China's operations.

We continued to build competitive advantage through cooperation with Industrial Bank in areas such as service delivery networks, customer referrals and wealth management. Our dual logo credit card has become one of the most favoured on the Mainland on the back of strong customer segment management and attractive value-added privileges.

Towards the end of 2008, we became the largest shareholder in Yantai City Commercial Bank – a major city commercial bank in Shandong – following the completion of an RMB800 million deal to purchase 20 per cent of the bank's enlarged share capital. This acquisition significantly increases our interests in the Bohai Economic Rim region.

Our total investment on the Mainland is now over RMB7.4 billion.

## Looking Ahead

Moving forward, deposits acquisition, particularly renminbi deposits, will remain a central part of our strategy for long-term growth, helping to support balance sheet structure and providing liquidity for future lending once markets stabilise.

In personal banking, we will leverage our expanding Mainland wealth management capabilities and extended service networks to grow our customer base, focusing particularly on the affluent and mass affluent segments. In January 2009, we launched two debit cards – the Hang Seng Card and Hang Seng Prestige Banking Card – offering customers increased flexibility in managing their finances.

We will work to remain among the market leaders in offering customised advice and investment products that meet a wide range of customer needs. This will also support efforts to grow fee-based business and further diversify income.

Commercial customers will continue to benefit from our cross-market capabilities and comprehensive trade services.

In 2008, we reinforced risk control through training, enhanced credit policies and lending guidelines, and an improved operational risk management framework. We will remain vigilant in our assessment and management of all business risks.

We will further capitalise on the extended reach, capabilities and business opportunities created by our strategic partnerships.



## **New Outlet Openings in 2008**

Kunming Branch

Tianjin Branch

Beijing Dongdan Sub-branch

Dongguan Chang An Sub-branch

Guangzhou Tianhe North Road Sub-branch

Guangzhou Wu Yang Xin Cheng Sub-branch

Nanjing Zhongshan East Road Sub-branch

Shanghai Zhaojiabang Road Sub-branch

Shenzhen Futian East Pacific Garden Sub-branch

Shenzhen Luohu Sub-branch

# MANAGEMENT DISCUSSION AND ANALYSIS

## - FINANCIAL REVIEW

### FINANCIAL PERFORMANCE

#### Income Statement

##### Summary of financial performance

Figures in HK\$m

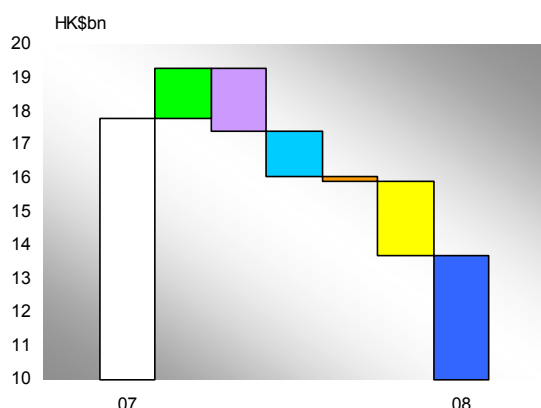
	<u>2008</u>	<u>2007</u>
Total operating income	34,759	35,692
Total operating expenses	6,795	6,650
Operating profit after loan impairment charges and other credit risk provisions	13,725	17,789
Profit before tax	15,878	21,471
Profit attributable to shareholders	14,099	18,242
Earnings per share (in HK\$)	7.37	9.54

Hang Seng Bank Limited ('the Bank') and its subsidiaries and associates ('the Group') reported an audited profit attributable to shareholders of HK\$14,099 million for 2008, down by 22.7 per cent compared with 2007. Earnings per share were HK\$7.37, down HK\$2.17 from 2007. Excluding the dilution gain arising from the Bank's strategic investment in Industrial Bank Co., Ltd. ('Industrial Bank') in 2007, profit attributable to shareholders fell by 16.0 per cent. Attributable profit to shareholders for the second half of 2008 decreased by HK\$4,029 million, or 44.5 per cent, when compared with the first half, adversely affected by lower wealth management income and higher loan impairment charges following the deepening of the global credit crisis and liquidity crunch.

**Operating profit excluding loan impairment charges and other credit risk provisions declined by HK\$1,864 million, or 10.1 per cent, to HK\$16,501 million.**

Although net interest income grew by 10.3 per cent as a result of asset and liability growth and improved net interest margin, this was more than offset by declining non-interest income in the second half of the year resulting from the worldwide economic downturn and deteriorating operating conditions.

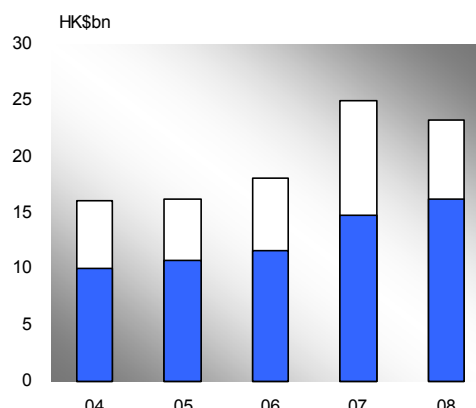
#### OPERATING PROFIT ANALYSIS



	HK\$m
□ 2007 OPERATING PROFIT	17,789
CHANGES DUE TO :	
■ NET INTEREST INCOME	1,513
■ NET FEE INCOME	(1,917)
■ OTHER OPERATING INCOME	(1,315)
■ OPERATING EXPENSES	(145)
■ LOAN IMPAIRMENT CHARGES AND OTHER CREDIT RISK PROVISIONS	(2,200)
■ 2008 OPERATING PROFIT	13,725

#### NET OPERATING INCOME

(Before loan impairment charges and other credit risk provisions)



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

**Net interest income rose by HK\$1,513 million, or 10.3 per cent, to HK\$16,232 million with a 4.0 per cent increase in average interest-earning assets.**

<i>Figures in HK\$m</i>	<u>2008</u>	<u>2007</u>
Net interest income/(expense) arising from:		
- financial assets and liabilities that are not at fair value through profit and loss	17,277	16,404
- trading assets and liabilities	(1,211)	(1,753)
- financial instruments designated at fair value	<u>166</u>	<u>68</u>
	<u>16,232</u>	<u>14,719</u>
Average interest-earning assets	688,252	661,469
Net interest spread	2.15%	1.84%
Net interest margin	2.36%	2.23%

Average customer advances rose 11.6 per cent, with notable increases in higher yielding personal loans, card advances, trade finance and Mainland loans. The active property market in first half of 2008 drove strong growth in average mortgage lending, but this was partly offset by compressed mortgage pricing in the intensely competitive and low interest rate environment. Overall, the total loan portfolio contributed HK\$846 million to the growth in net interest income.

Benefiting from low market interest rates, Treasury balance sheet management income registered strong growth, contributing HK\$1,370 million to the increase in net interest income. The interest earned from the life insurance funds investment portfolio also recorded encouraging growth of HK\$473 million, reflecting the increase in the size of the portfolio.

Average customer deposits grew by 6.8 per cent, mainly reflecting increases in savings and foreign currency time deposits. However, the favourable impact of the growth in deposits and low-cost savings balances were more than offset by narrower time deposit spreads with little room to reduce customer rates under the low interest rate environment. Net interest income from deposit products fell by HK\$270 million.

The contribution from net free funds fell by HK\$906 million due to the decrease in market interest rates, but this was partly offset by the increase in level of net free funds (including non-interest-bearing account balances and net shareholders' funds).

Net interest margin rose by 13 basis points to 2.36 per cent. Net interest spread increased by 31 basis points to 2.15 per cent, benefiting from growth in low cost customer deposits, better yields on the Treasury balance sheet management portfolios and the lagged effect of asset re-pricing following several prime interest rate cuts in 2008. Contribution from net free funds, however, fell by 18 basis points to 0.21 per cent as a result of the fall in market interest rates. Including the net decrease of HK\$305 million in funding swap costs – which were recognised as foreign exchange losses under trading income – net interest income increased by HK\$1,818 million, or 12.8 per cent, and net interest margin improved by 18 basis points to 2.34 per cent.

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>2008</u>	<u>2007</u>
Net interest income	17,233	16,358
Average interest-earning assets	664,750	643,655
Net interest spread	2.34%	1.98%
Net interest margin	2.59%	2.54%

**Net fee income fell by HK\$1,917 million, or 27.8 per cent, to HK\$4,969 million, compared with 2007.**

Hang Seng achieved good growth in stockbroking and related services, retail investment funds and sales of structured investment products in the first half of 2008. However, the worldwide economic downturn drove a sharp deterioration in the operating environment in the second half of 2008, adversely affecting many business activities that generate fee-based income. Revenue from stockbroking and related services, retail investment funds and sales of structured investment products fell by 31.5 per cent, 35.3 per cent and 48.4 per cent respectively for the full year. Private banking investment services fee income dropped by 76.6 per cent as customers become more conservative towards investment.

Card services income sustained good growth momentum, rising by 24.4 per cent on the back of the increase in number of cards in circulation as well as the 15.9 per cent rise in card spending and the 38.6 per cent growth in merchant sales. The launch of the Hang Seng enJoy card, which employs contactless payment technology, was well received by the market and helped to boost the number of cards in issue by about 13.4 per cent.

Remittances and credit facilities rose by 9.8 per cent and 20.0 per cent respectively.

Compared with the first half of 2008, net fee income in the second half fell by HK\$1,085 million, or 35.8 per cent, due mainly to declines in income from stockbroking and related services, retail investment funds and private banking.

**Trading income dropped by HK\$224 million, or 13.3 per cent, to HK\$1,455 million, compared with 2007.**

The HK\$523 million increase in foreign exchange income takes into account two specific items not related to normal foreign exchange trading. First, an exchange loss of HK\$156 million was incurred in 2008 (HK\$461 million in 2007) on forward contracts employing 'funding swap' activities<sup>†</sup> in the balance sheet management portfolios. Also, the revaluation loss on the US dollars capital funds of Hang Seng China amounted to HK\$194 million in 2008 (HK\$171 million in 2007). The capital funds were injected in US dollars and pending regulatory approval for conversion into Chinese renminbi, and the revaluation against Chinese renminbi was recognised as a foreign exchange loss. Excluding these two unfavourable items, normal foreign exchange trading registered encouraging growth of HK\$241 million, or 16.1 per cent, reflecting the Bank's ability to capture good opportunities to sustain its income from proprietary trading and customer-driven business (particularly foreign exchange-linked products) in volatile financial market conditions. The Bank will work to further develop sustainable competitive advantages in this area by enhancing product pricing, sales synergy and system support when launching innovative products in both Hong Kong and the Mainland.

Income from securities, derivatives and other trading activities fell by HK\$747 million, or 91.3 per cent, due to lower demand for equity-linked structured products and unfavourable trading results.

<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\$1,031 million, compared with a HK\$1,907 million gain in 2007.**

This was mainly reflecting the weak performance of the investment assets of the life insurance portfolio in the turbulent market conditions of 2008. In response to the volatile global stock market, the equity component of the investment portfolios has been replaced substantially by high quality debt securities. As a result, the investment loss was contained at a relatively low level of HK\$15 million in the second half of 2008 when compared with a loss of HK\$1,030 million in the first half.

**Net earned insurance premiums rose by HK\$2,649 million, or 27.3 per cent. Net insurance claims incurred and movement in policyholders' liabilities rose by HK\$786 million, or 7.4 per cent.**

The Bank's life insurance business continued to gain market share and was ranked first in Hong Kong in terms of new annualized regular life insurance premiums in the first nine months of 2008. The increase in movement in policyholders' liabilities is largely in line with the increase in premium income.

### Analysis of income from wealth management business

Figures in HK\$m

	<u>2008</u>	<u>2007</u>
Investment income:		
- retail investment funds	1,084	1,676
- structured investment products <sup>†</sup>	882	1,492
- private banking <sup>††</sup>	248	1,009
- securities broking and related services	1,359	1,985
- margin trading and others	119	78
	<b>3,692</b>	<b>6,240</b>
Insurance income:		
- life insurance	1,383	2,055
- general insurance and others	314	348
	<b>1,697</b>	<b>2,403</b>
Total	<b><u>5,389</u></b>	<b><u>8,643</u></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 remained strong and maintained balanced growth in the first half of 2008, but was subsequently affected by the global economic turmoil and deteriorating economic environment in the second half of the year. Investment income and insurance income for 2008 fell by 40.8 per cent and 29.4 per cent respectively when compared with a year earlier.

While the operating environment deteriorated rapidly and many financial institutions were impacted in the second half of 2008, the Bank's adaptable wealth management strategy proved successful in maintaining its leadership position in the market by providing diversified income streams from a wide product range. To offer greater peace of mind to customers amid the financial market turmoil, the focus of wealth management sales was shifted to highly defensive products, such as capital-protected investments and life insurance. The Bank's reputation for stringent risk control in the development and selection of the suitable products for customers proved an important competitive advantage and further strengthened the Bank's position as one of the most preferred financial institutions in Hong Kong.

The worldwide economic downturn that took hold in the second half of 2008 adversely affected financial markets-related income. Although the Bank offers a wide variety of investment funds to meet the changing risk appetites of investors, investment fund income (including sales commissions and management fees) fell by 35.3 per cent to HK\$1,084 million with turnover down by 69.6 per cent. Funds under management (excluding private banking) declined by 37.3 per cent to HK\$51.5 billion compared with the end of 2007, due mostly to a decline in the market value of the funds resulting from declining financial market values.

Throughout the year, equity markets remained difficult and market values trended sharply downward. The Bank continued to distribute a wide range of structured products offering flexibility of investment options and potential returns, but with increasing investor caution, income from structured investment products declined by 40.9 per cent. The sluggish equity markets also affected securities broking and related services income, which fell by 31.5 per cent to HK\$1,359 million.

Following strong growth in 2007, Private Banking was adversely affected by weak investment sentiment. This led to lower customer transactions and a 75.4 per cent decrease in wealth management income for 2008. Private banking's customer base maintained stable growth, which will help support a solid recovery in income growth once financial markets stabilise and investor confidence returns. Assets under management dropped by 42.0 per cent, due largely to the fall in the market value of assets under the volatile financial conditions.

Life insurance income declined by HK\$672 million, or 32.7 per cent, to HK\$1,383 million (analysed in the table below). Despite poor investment sentiment, the Bank was able to sustain its robust growth in life insurance, topping the league in terms of new annualised regular life insurance premiums for the first three quarters of the year and gaining market share. The Bank continued to enhance its strong position in providing retirement savings and protection products to its banking customers. New features were added to the Bank's flagship life insurance product – the Income Select Life Insurance Plan. Net earned insurance premiums were up by HK\$2,629 million, or 28.0 per cent. In response to the volatile global stock markets, the equity component of the life insurance funds investment portfolio has been replaced substantially by debt securities. As a result, net interest income from life insurance business rose significantly by 47.5 per cent due to the growth in investment portfolio size. In addition, the loss on investment returns on life insurance funds was significantly contained at a low level of HK\$35 million in second half when compared with the loss of HK\$1,030 million in the first half of the year.

General insurance income dropped by 9.8 per cent to HK\$314 million.

Figures in HK\$m

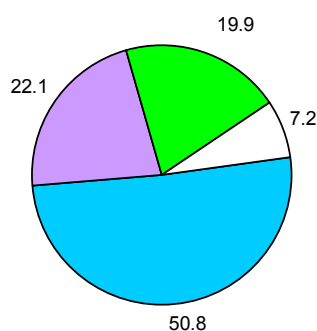
	2008	2007
Life insurance:		
- net interest income and fee income	1,400	943
- investment returns on life insurance funds	(1,065)	1,903
- net earned insurance premiums	12,023	9,394
- claims, benefits and surrenders paid	(676)	(609)
- movement in policyholders' liabilities <sup>†</sup>	(10,703)	(9,991)
- reinsurers' share of claims incurred and movement in policyholders' liabilities	22	18
- movement in present value of in-force long-term insurance business	382	397
	<b>1,383</b>	<b>2,055</b>
General insurance and others	<b>314</b>	<b>348</b>
Total	<b>1,697</b>	<b>2,403</b>

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

Operating expenses rose by HK\$145 million, or 2.2 per cent, to HK\$6,795 million.

#### OPERATING EXPENSES FOR 2008

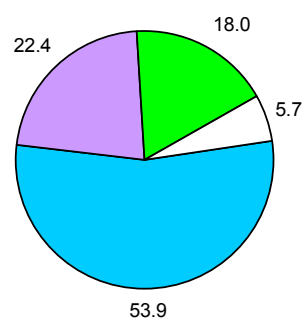
IN PERCENTAGE



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

#### OPERATING EXPENSES FOR 2007

IN PERCENTAGE



Operating expenses rose slightly by HK\$145 million, reflecting the Bank's traditional cost discipline in the difficult economic environment. Excluding Mainland operations, operating expenses fell slightly by 2.7 per cent.

Employee compensation and benefits declined by HK\$133 million. Salaries and other costs increased by 15.3 per cent, reflecting the annual salary increment and an increase in the number of full-time equivalent staff. Performance-related pay expenses were down 57.8 per cent while retirement benefit costs increased due to the change in actuarial assumptions made on the expected rate of salary increases at the end of 2007. General and administrative expenses rose by 6.2 per cent. Increasing rental costs for branches in Hong Kong, new branches in the Mainland and the Bank's large office premises in Kowloon Bay resulted in higher rental costs. IT costs also rose. These expenses were partly offset by controlled spending in marketing and advertising. Depreciation was up by HK\$84 million due to the acquisition of equipment, fixtures and fittings for the Bank's Kowloon Bay office and Headquarters building in Central.

<b>Staff numbers<sup>†</sup> by region</b>	<b>2008</b>	<b>2007</b>
Hong Kong	8,256	8,033
Mainland	1,450	1,097
Others	58	60
Total	<u>9,764</u>	<u>9,190</u>

<sup>†</sup> Full-time equivalent

The number of full-time equivalent staff rose by 574 compared with 2007 year-end. New hires to support Hang Seng China's Mainland expansion accounted for 61.5 per cent of the total rise. The remaining increase was due to investment in the expansion of CMB's relationship management and wealth management teams as well as IT systems development needs.

The cost efficiency ratio for 2008 was 29.2 per cent, compared with 26.6 per cent in 2007.

**Operating profit** was down by HK\$4,064 million, or 22.8 per cent, to HK\$13,725 million, after accounting for the HK\$2,200 million increase in **loan impairment charges and other credit risk provisions** in the deteriorating economic conditions.

**Loan impairment charges and other credit risk provisions significantly increased by HK\$2,200 million, or 381.9 per cent, to HK\$2,776 million.**

<i>Figures in HK\$m</i>	<b>2008</b>	<b>2007</b>
Loan impairment charges:		
- individually assessed	(925)	(250)
- collectively assessed	(476)	(326)
	<u>(1,401)</u>	<u>(576)</u>
of which:		
- new and additional	(1,505)	(702)
- releases	48	64
- recoveries	56	62
	<u>(1,401)</u>	<u>(576)</u>
Other provision	<u>(1,375)</u>	—
Loan impairment charges and other credit risk provisions	<u>(2,776)</u>	<u>(576)</u>

The charge for individually assessed impairment provisions increased by HK\$675 million, or 270.0 per cent, due mainly to the downgrading of certain corporate and commercial banking customers in the weakening credit environment. However, these provisions were partly offset by a net release on the mortgage portfolio.

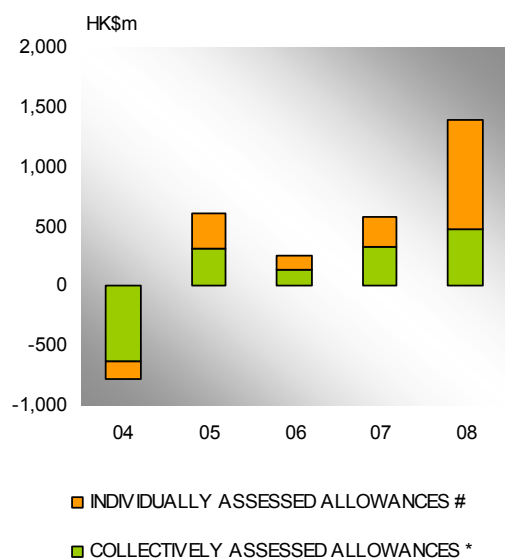
Collectively assessed provisions rose by HK\$150 million, or 46.0 per cent, reflecting the combined effect of the HK\$81 million rise in allowances on card and personal loan portfolios and the HK\$69 million increase in allowances for loans not individually identified as impaired as a result of the periodical update of historical loss rates to reflect the turbulence of the global credit markets.

Other credit risk provisions registered an impairment charge of HK\$1,375 million in 2008. During the third quarter, growing volatility in major financial markets had an adverse impact on Hang Seng's investment securities. The Bank wrote down the carrying value of certain available-for-sale debt securities and made an impairment charge of HK\$1,375 million.

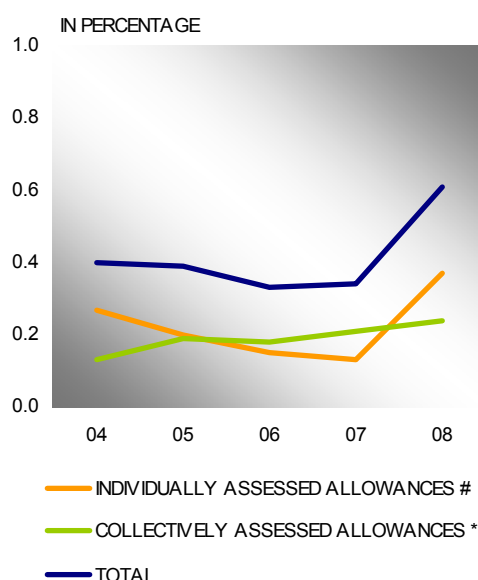
Total loan impairment allowances as a percentage of gross advances to customers are as follows:

	<i>At 31 December</i> <b>2008</b>	<i>At 31 December</i> <b>2007</b>
	%	%
Loan impairment allowances:		
- individually assessed	<b>0.37</b>	0.13
- collectively assessed	<b>0.24</b>	0.21
Total loan impairment allowances	<b>0.61</b>	0.34

**NET CHARGES / (RELEASES) FOR  
LOAN IMPAIRMENT ALLOWANCES**



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



# For 2004, individually assessed allowances merely include the specific provision assessed on individual basis.

\* For 2004, collectively assessed allowances include the specific provision assessed on portfolio basis plus general provision.



## Attributable profit

**Profit before tax** was down HK\$5,593 million, or 26.0 per cent, to HK\$15,878 million, in part reflecting a HK\$1,465 million **gain on dilution of investment in an associate** related to the listing of Industrial Bank in 2007 and an increase of HK\$685 million in **share of profits from associates**, mainly contributed by Industrial Bank. These were partly offset by a decrease of HK\$300 million in **net surplus on property revaluation** and a decrease of HK\$449 million in **gains less losses from financial investments and fixed assets**.

**Gains less losses from financial investments and fixed assets amounted to HK\$267 million, a decrease of 62.7 per cent compared with 2007.**

Net gains from the disposal of available-for-sale equity securities rose by HK\$197 million, or 43.9 per cent, to HK\$646 million, and comprised primarily profit realised from the partial disposal of shares held in MasterCard Inc. and the redemption of shares in Visa Inc. following its IPO early in 2008. In accordance with Hong Kong accounting standards, an impairment charge of HK\$284 million was made for certain available-for-sale equity securities. Gains less losses on disposal of investment properties was lower due to fewer property disposals.

**Net surplus on property revaluation fell by 79.2 per cent to HK\$79 million.**

Figures in HK\$m

	<u>2008</u>	<u>2007</u>
Net surplus on property revaluation:		
- investment properties	8	250
- assets held for sale	-	95
Reversal of revaluation deficit on premises	<u>71</u>	<u>34</u>
	<u><u>79</u></u>	<u><u>379</u></u>

On 30 September 2008, the Group's premises and investment properties were revalued by DTZ Debenham Tie Leung Limited and were adjusted for material change in the valuation as at 31 December 2008. 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 revaluation surplus for Group premises amounted to HK\$242 million of which HK\$71 million was a reversal of revaluation deficits previously charged to the income statement. The balance of HK\$171 million was credited to the premises revaluation reserve. Revaluation gains of HK\$8 million on investment properties were recognised through the income statement. The related deferred tax provisions for Group premises and investment properties were HK\$40 million and HK\$1 million respectively.

The revaluation exercise also covered investment properties reclassified as properties held for sale. In accordance with HKFRS 5, the revaluation deficit of HK\$8 million was 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</i>
<b>Year ended 31 December 2008</b>						
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>
<b>Year ended 31 December 2007</b>						
Profit before tax	<u>11,918</u>	<u>2,701</u>	<u>475</u>	<u>1,829</u>	<u>4,548</u>	<u>21,471</u>
Share of profit before tax	<u>55.5%</u>	<u>12.6%</u>	<u>2.2%</u>	<u>8.5%</u>	<u>21.2%</u>	<u>100.0%</u>

**Personal Financial Services ('PFS')** reported a profit before tax of HK\$8,410 million for 2008, 29.4 per cent lower than last year, due largely to the adverse impact of the global economic downturn on wealth management business in the second half of the year. Operating profit excluding loan impairment charges was down 30.2 per cent at HK\$8,467 million.

Net interest income remained at the same level as last year, supported mainly by the strong performance of unsecured lending, which offset narrowing margins on deposits and secured lending caused by falling interest rates.

Unsecured lending business recorded a significant year-on-year growth of 31.5 per cent in total operating income, underpinned by the satisfactory growth of credit cards-in-force as well as cards spending and receivables. The launch of a new credit card employing contactless payment technology and a series of promotional campaigns helped increase the number of cards in issue to 1.73 million, representing year-on-year growth of 13.4 per cent. Card receivables rose by 13.1 per cent year-on-year to reach HK\$12.8 billion, attributable mainly to successful card utilisation campaigns. Personal lending also registered impressive growth with an 18.9 per cent year-on-year increase in loan balances to HK\$3.3 billion.

Residential mortgage business paralleled the property market slow down in the second half of the year, but the Bank maintained its market share in terms of total mortgage loans, which stood at 15.3 per cent as of 31 December 2008.

Non-interest income fell by 43.4 per cent. With increasingly negative investor sentiment, fee income from the selling of investment products, securities trading and private banking declined significantly. Investment returns on life insurance business were badly hit by the troubled financial markets. Nevertheless, sales of life insurance broke new record of over HK\$3 billion in new annualised premiums – representing year-on-year growth of 45.0 per cent and resulting in a number one ranking in Hong Kong in terms of new business for the first three quarters of the year with a market share of 13.4 per cent.

PFS continued to strengthen its positioning in young customer segments and promote self-directed banking behaviours with the launch of a Green Banking account, a new account for tertiary students that offers secure online banking services and Hong Kong's first virtual identity bank card to facilitate secured online payment using digital certificate.

Personal e-banking continued its steady growth in 2008 with over 870,000 registered customers. The Internet channel was further developed in line with its position as a major transaction media and accounted for 75 per cent of total securities trading transactions.

**Commercial Banking ('CMB')** reported year-on-year increases in every major income category despite the challenging market conditions, with operating profit excluding loan impairment charges rising by 6.5 per cent to HK\$2,354 million. However, with increased loan impairment charges in the deteriorating business environment, profit before tax dropped by 8.6 per cent to HK\$2,470 million. CMB contributed 15.6 per cent to the Bank's total profit before tax in 2008, up 3.0 percentage points on a year earlier.

Average customer advances rose by 14.5 per cent. Falling commodity prices and international trade caused a 15.3 per cent year-on-year decline in trade finance, while factoring advances grew by 2.8 per cent. The overall reduction in interest rates dragged down deposit spreads, offsetting a strong 14.7 per cent increase in net interest income from advances to result in a 2.0 per cent overall increase in net interest income.

Other operating income achieved year-on-year growth of 11.8 per cent with increases seen in all major non-interest income categories. Despite challenging market conditions, Corporate Wealth Management income achieved a 4.5 per cent increase and contributed 10.4 per cent of CMB's total operating income. Following good growth in the first half of 2008, investment and treasury business was affected by weak investment sentiment and volatile market conditions in the second half, leading to a moderate income growth of 2.7 per cent for the year. Corporate life insurance business benefited from improved product offerings and sales training, leading to a 96.6 per cent increase in income.

The successful launch of express China remittance services in cooperation with Hang Seng Bank (China) Limited, Industrial Bank and Bank of Communications underpinned encouraging

improvements in our outward remittance market share. Through these strengthened services, our customers can now make same-day remittances to about 100 key cities on the Mainland.

Alongside increased collaboration among the Hong Kong, Mainland and Macau teams, a branding programme was rolled out in September 2008 to establish the Bank as the financial institution of choice for middle-market enterprises ('MMEs') which are in need of one-stop cross-border financial services.

CMB continued to improve its position in the merchant-acquiring business by offering total banking solutions to retailers. Fee income from card merchant-acquiring saw good growth of 27.2 per cent. Octopus card merchant services remained an important source of new customer acquisitions, with around 70 per cent of Octopus card merchants acquired in 2008 being new customers for the Bank. The overall number of new commercial customers acquired in 2008 rose by 5.5 per cent.

As of 31 December 2008, more than 64,000 customers had registered for Business e-Banking services, a year-on-year increase of 26.5 per cent. Business e-Banking securities trading services were introduced in August 2008 to provide commercial customers with an efficient and convenient trading platform. The number of online business banking transactions grew by 27.8 per cent compared with 2007. To further expand service channels, the services of two Business Banking Centres were extended to offer automated banking and counter services for commercial customers.

**Corporate Banking ('CIB')** achieved an increase of 36.3 per cent in operating profit excluding loan impairment charges, driven largely by satisfactory growth of 37.4 per cent in net interest income. Average customer deposits rose by 5.4 per cent. Average customer advances were up 7.9 per cent, due mainly to increased lending to property development and building & construction companies. Profit before tax rose strongly by HK\$170 million, or 35.8 per cent, to HK\$645 million.

Our restraint in asset growth leading up to 2008 has served us well. Throughout 2008, CIB has been able to support its customers with new or renewed facilities at good risk-adjusted returns. Net interest income from advances grew by 45.3 per cent.

CIB remained active in financing Mainland projects of Hong Kong-based corporations during 2008 and continued to expand its Mainland customer base. Average customer deposits on the Mainland recorded encouraging growth of 50.9 per cent while loan balances remained flat due to macro-economic control and repayments.

**Treasury ('TRY')** reported a strong growth of 87.0 per cent in operating income, due mainly to improved interest margins on the balance sheet management portfolio under low global interest rates.

In the face of slowing economic activity and the growing credit crisis, Treasury further strengthened its prudent risk management strategy. By rebalancing its investment portfolio with a particular focus on investing in high quality papers, Treasury achieved an impressive HK\$1,370 million, or 104.4 per cent, increase in net interest income from balance sheet management portfolios.

Net trading income also recorded encouraging growth of 37.0 per cent, or HK\$173 million. Income from foreign exchange spot and derivative trading remained the central pillar of trading income. In the uncertain market conditions, sales of capital-protected investment instruments and other foreign exchange linked products enjoyed strong growth.

The financial turmoil that took hold of markets in the second half of the year affected the credit quality of some investments under the balance sheet management portfolio, resulting in an impairment provision of HK\$1,375 million, which partly offset the growth in operating income.

Despite the credit challenges, profit before tax taking into account the increase in share of profits from associates grew by 24.6 per cent to HK\$2,279 million, contributing 14.4 per cent to the Group's total profit before tax.

## Mainland Business

Headquartered in Shanghai, the Bank's Mainland subsidiary, Hang Seng Bank (China) Limited ('Hang Seng China'), marked its first anniversary in May 2008. At the end of 2008, Hang Seng China operated a network of 33 outlets in Beijing, Shanghai, Guangzhou, Dongguan, Shenzhen, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin and Kunming. The Bank has a branch in Shenzhen for foreign currency wholesale business and a representative office in Xiamen.

To strengthen its foothold in the rapidly developing Bohai Economic Rim region, in January 2008 the Bank signed an agreement to subscribe for 20 per cent of the enlarged share capital of Yantai City Commercial Bank ('YTCCB') – one of the largest city commercial banks in Shandong Province – for a consideration of RMB800 million. The Bank obtained formal approval for the deal from the China Banking Regulatory Commission on 5 December 2008 and paid the purchase consideration to YTCCB on 31 December 2008.

Hang Seng China set up strategic business collaborations during 2008, working with various insurance companies to enrich its insurance product offerings, expanding its mortgage loan business by cooperating with a guarantee company and property agencies, providing additional Chinese renminbi depository channels and express China remittance services through partnering with Mainland banks, and preparing for the issuance of a debit card and expanding its service channel coverage by joining China UnionPay.

These developments helped solidify relationships with existing customers and reach out to new ones, with the number of Prestige Banking customers and corporate customers up by 154 per cent and 20 per cent respectively. Under the current economic turmoil, balance sheet structure was further improved by successful efforts to build a stronger deposit base. Total operating income rose by 63.7 per cent, benefiting from impressive increases in both non-interest income and net interest income, supported by a 3.7 per cent increase in customer advances and a strong 91.8 per cent growth in customer deposits. Profit before tax fell substantially, affected by the cost of investments in human resources and branch network, an exchange loss on US dollar capital funds upon revaluation against the Chinese renminbi, and an increase in loan impairment charges.

Including the Bank's share of profit from Industrial Bank, Mainland business contributed 11.9 per cent of total profit before tax, compared with 6.5 per cent in 2007.

## Economic Profit

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

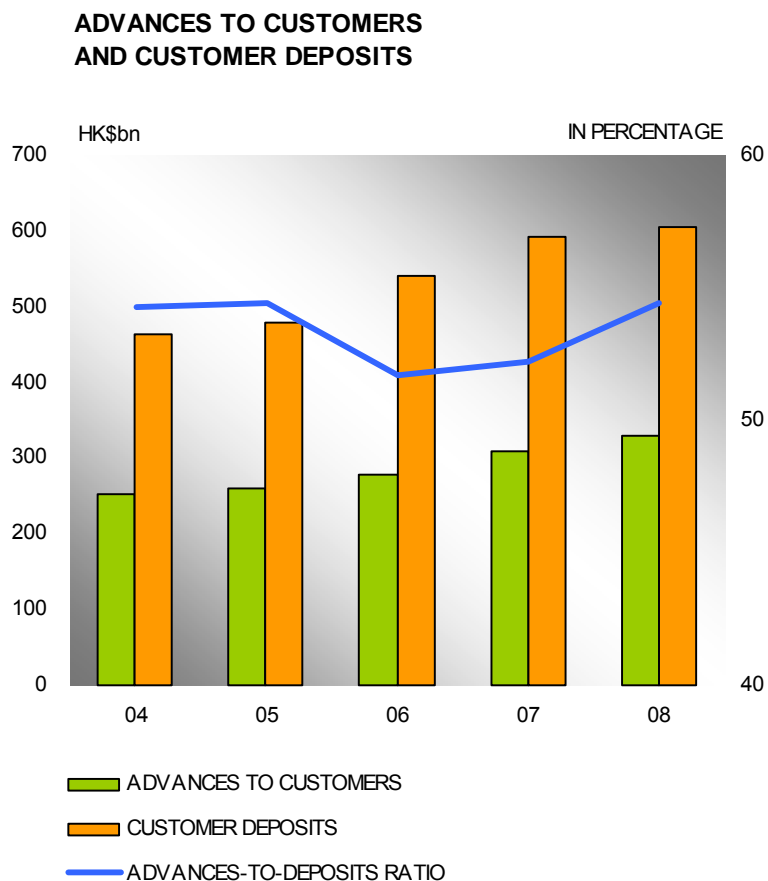
For the year 2008, economic profit was HK\$8,804 million, a decrease of HK\$3,893 million, or 30.7 per cent, compared with 2007. Post-tax profit, adjusted for the property revaluation surplus net of deferred tax and depreciation attributable to the revaluation, fell by HK\$3,879 million. Cost of capital rose by HK\$14 million, in line with the growth in invested capital with the accumulation of retained profits.

	2008		2007	
	HK\$m	%	HK\$m	%
Average invested capital	<u>53,866</u>		<u>46,051</u>	
Return on invested capital <sup>†</sup>	<b>14,120</b>	<b>26.2</b>	17,999	39.1
Cost of capital	<u>(5,316)</u>	<u>(9.9)</u>	<u>(5,302)</u>	<u>(11.5)</u>
Economic profit	<b>8,804</b>	<b>16.3</b>	<b>12,697</b>	<b>27.6</b>

<sup>†</sup> Return on invested capital is based on post-tax profit excluding any surplus/deficit arising from property revaluation and depreciation attributable to the revaluation surplus.

## Balance Sheet

**Total assets** increased by HK\$16.2 billion, or 2.2 per cent, to HK\$762.2 billion. Customer advances rose by 6.7 per cent. In line with the Bank's strategy to diversify its loan portfolio, encouraging growth was recorded in Mainland lending, commercial lending, cards and personal loans. The Bank took good advantage of opportunities to grow its residential mortgage lending in the active property market during the first half of 2008. In light of the unprecedented turbulence in the financial market and the interventions by the government and central bank to stabilise the financial system, the Bank has continued reducing its available-for-sale debt securities holdings and shifted to debt securities issued or guaranteed by the government and central bank. Customer deposits increased by HK\$13.9 billion, or 2.3 per cent, to HK\$604.5 billion. At 31 December 2008, the advances-to-deposits ratio was 54.4 per cent, compared with 52.2 per cent at the end of 2007.



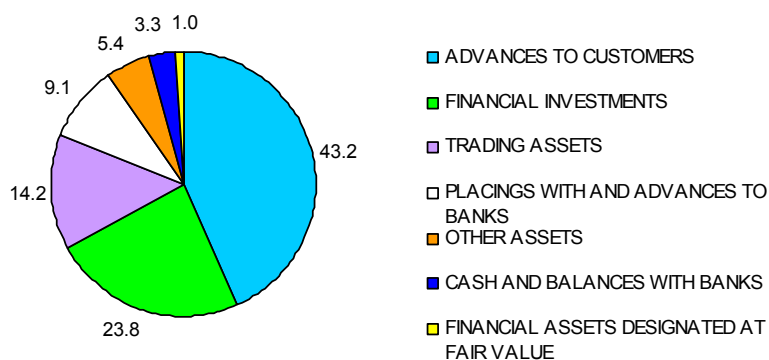
## Assets deployment

Figures in HK\$m

	2008	%	2007	%
Cash and balances with banks and other financial institutions	24,822	3.3	16,864	2.3
Placings with and advances to banks and other financial institutions	69,579	9.1	113,029	15.2
Trading assets	108,389	14.2	10,390	1.4
Financial assets designated at fair value	7,798	1.0	13,892	1.9
Advances to customers	329,121	43.2	308,356	41.3
Financial investments	181,159	23.8	244,294	32.7
Other assets	41,300	5.4	39,174	5.2
<b>Total assets</b>	<b>762,168</b>	<b>100.0</b>	<b>745,999</b>	<b>100.0</b>

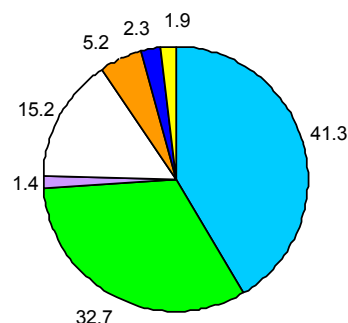
### ASSETS DEPLOYMENT FOR 2008

IN PERCENTAGE



### ASSETS DEPLOYMENT FOR 2007

IN PERCENTAGE



## Advances to customers

Gross advances to customers rose by HK\$21.8 billion, or 7.0 per cent, to HK\$331.2 billion compared with the previous year-end.

The Bank proactively managed its loan book amid the changing credit environment, enabling it to capture good business opportunities in the first half of 2008 and record encouraging growth in industrial, commercial and financial sectors during the year. Lending to property development and property investment increased satisfactorily by 23.9 per cent and 21.0 per cent respectively against the backdrop of the buoyant property market in the first half of 2008. Lending to manufacturing sectors grew by 54.3 per cent while lending to transport and transport equipment fell by 10.3 per cent, mainly due to loan repayments.

Trade finance dropped by 17.2 per cent, reflecting the sustained contraction of exports to the US, the Mainland and major Asian markets.

Lending to individuals recorded a rise of 1.8 per cent despite the economic downturn. Excluding the fall in Government Home Ownership Scheme ('GHOS') mortgages, lending to individuals grew by 3.6 per cent. Residential mortgages to individuals rose by 4.4 per cent as the Bank was able to capture business opportunities arising from the booming property market in the first half of 2008 by leveraging its e-Mortgage service and mortgage consultants to offer a premium mortgage solution. Although economic conditions led to a decline in property market activity during the second half, the Bank was able to maintain its position as one of the market leaders amid intense market competition.

Credit card business registered strong growth, with card advances growing by 13.1 per cent. This was supported by a rise of 13.4 per cent in the number of cards in issue and a 15.9 per cent increase in card spending, mainly due to successful card customer acquisition and card utilisation campaigns.

Loans for use outside Hong Kong increased by HK\$3,312 million, or 10.2 per cent, compared with the end of 2007. This was due largely to the 3.7 per cent growth in the mainland loan portfolio, which had reached HK\$26.9 billion at 31 December 2008. The Bank employed a cautious approach to lending on the Mainland and will continue to strengthen its prudent credit risk policies in light of the more difficult operating conditions for businesses.

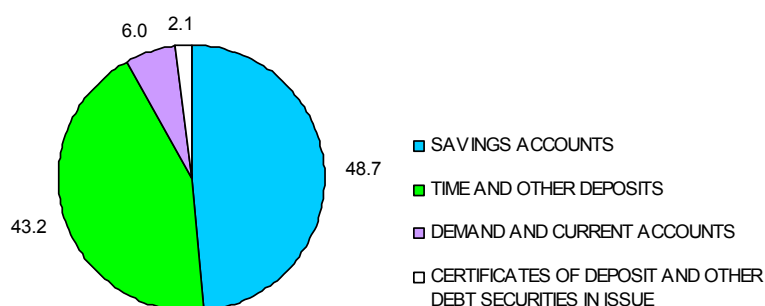
### Customer deposits

Customer deposits, certificates of deposit and other debt securities in issue rose by HK\$13.9 billion, or 2.3 per cent, to HK\$604.5 billion, largely due to increases in Hong Kong dollar and United States dollar savings accounts and mainland deposits.

In tandem with the expanding scope of Chinese renminbi banking services offered by Hang Seng China, deposits from mainland branches registered impressive growth of 91.8 per cent. Hang Seng China will continue building an integrated network via its expanding outlet presence in key cities and provide premium services to grow its customer base.

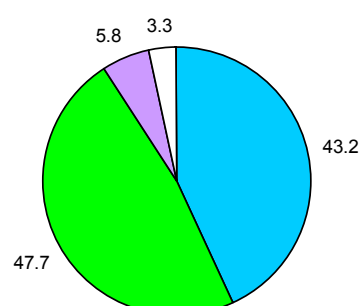
**CUSTOMER DEPOSITS FOR 2008**

IN PERCENTAGE



**CUSTOMER DEPOSITS FOR 2007**

IN PERCENTAGE



### Subordinated liabilities

There was no subordinated debt issued during 2008. 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>2008</u>	<u>2007</u>
Share capital	<b>9,559</b>	9,559
Retained profits	<b>32,518</b>	32,873
Premises revaluation reserve	<b>3,711</b>	3,639
Cash flow hedges reserve	<b>562</b>	144
Available-for-sale investments reserve		
- on debt securities	<b>(4,137)</b>	(841)
- on equity securities	<b>314</b>	2,733
Capital redemption reserve	<b>99</b>	99
Other reserves	<b>3,264</b>	2,514
Total reserves	<b>36,331</b>	41,161
	<b>45,890</b>	50,720
Proposed dividends	<b>5,736</b>	5,736
Shareholders' funds	<b>51,626</b>	56,456
	<b>26.0%</b>	35.4%

Shareholders' funds (excluding proposed dividends) decreased by HK\$4,830 million, or 9.5 per cent, to HK\$45,890 million at 31 December 2008. Retained profits were down by HK\$355 million, reflecting the

increase in actuarial loss on the defined benefit scheme during the year. The available-for-sale investments reserve (including debt and equity securities) showed a deficit of HK\$3,823 million compared with a surplus of HK\$1,892 million in 2007.

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 balance sheet date 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\$4,137 million compared with a deficit of HK\$841 million at the end of 2007, reflecting the mark down of debt securities, predominantly through reserves as credit spreads widened after the outbreak of global credit crisis and the liquidity crunch. The Group has assessed that the impairment provision on debt securities at 31 December 2008 was adequate and sufficient.

The available-for-sale investments reserve for equity securities fell by HK\$2,419 million to HK\$314 million compared with 2007 year-end, due mainly to the decrease in the fair value of certain equity securities which were adversely affected by the slowdown of the equities markets and the release of reserves upon the disposal of equity securities during the year.

The return on average shareholders' funds was 26.0 per cent, compared with 35.4 per cent for 2007.

There was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities in 2008.



## 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, insurance, operational and reputational risks. 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. The risk management policies and major control limits are approved by the Board of Directors. 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 and interest rate 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 treating customers fairly, conflicts of interest, money laundering deterrence, environmental impact and anti-corruption measures. The reputation 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 Kuo Fung CH' IEN** GBS, CBE, JP

Chairman

Dr Ch'ien, aged 57, is an independent non-executive Chairman of the Bank. He has been a Director of the Bank since August 2007. He is Chairman of CDC Corporation (Listed on NASDAQ) and Chairman of its Hong Kong listed subsidiary, China.com Inc. He is also Chairman of MTR Corporation Limited and HSBC Private Equity (Asia) Limited. Dr Ch'ien serves on the boards of The Hongkong and Shanghai Banking Corporation Limited, Inchcape plc, Convenience Retail Asia Limited, The Wharf (Holdings) Limited and Swiss Reinsurance Company. He is also Chairman of the Hong Kong/European Union Business Cooperation Committee; a Hong Kong member of the APEC Business Advisory Council; a member of the Standing Committee of the Tianjin Municipal Committee of the Chinese People's Political Consultative Conference; and Honorary President and past Chairman of the Federation of Hong Kong Industries. Dr Ch'ien was an independent non-executive Director of HSBC Holdings plc from 1998 to 2007, and Group Managing Director of Lam Soon Hong Kong Group from 1984 to 1997. From 1992 to 1997, he served as a member of the Executive Council of Hong Kong, then under British Administration. He then served as a member of the Executive Council of the HKSAR from July 1997 to June 2002. Dr Ch'ien was formerly Chairman of the Advisory Committee on Corruption of the Independent Commission Against Corruption, The Hong Kong/Japan Business Cooperation Committee, the Industry and Technology Development Council and the Hong Kong Industrial Technology Centre Corporation Limited. Dr Ch'ien was appointed a Justice of the Peace in 1993 and awarded a Commander in the Most Excellent Order of the British Empire in 1994, the Gold Bauhinia Star in 1999 and Chevalier de l'Ordre du Merite Agricole (of France) in 2008.

Dr Ch'ien received a doctoral degree in economics from the University of Pennsylvania in the USA in 1978 and became a Trustee of the University in 2006.

### **Mr OR Ching Fai Raymond JP**

Vice-Chairman and Chief Executive

Mr Or, aged 59, is Vice-Chairman and Chief Executive and a Member of the Executive Committee of the Bank. He has been a Director of the Bank since February 2000. He is a Director of The Hongkong and Shanghai Banking Corporation Limited; Chairman of Hang Seng Bank (China) Limited, Haseba Investment Company Limited, Hang Seng Insurance Company Limited and Hang Seng Life Limited; and a Director of Barrowgate Limited. He is also a Director of Cathay Pacific Airways Limited, Esprit Holdings Limited and Hutchison Whampoa Limited; Vice President and a Council Member of the Hong Kong Institute of Bankers; Chairman of Hang Seng School of Commerce; Deputy Chairman of the Council of The City University of Hong Kong and a Council Member of The University of Hong Kong; an adviser of the Employers' Federation of Hong Kong; a member of Chinese People's Political Consultation Conference Beijing Committee; a Director of 2009 East Asian Games (Hong Kong) Limited; Chairman of Campaign Committee and a member of the Board of The Community Chest of Hong Kong; and a member of the Board of Trustees of the Ho Leung Ho Lee Foundation. He was Vice Chairman of the Hong Kong Association of Banks from 2004 to April 2005 after presiding as Chairman in 2000 and 2003. He was a Director of Hong Kong Interbank Clearing Limited from 2000 to 2005 and Bank of Communications Co., Ltd from 2004 to 2005.

Mr Or began his career with The Hongkong and Shanghai Banking Corporation Limited in 1972 after receiving a Bachelor's degree in Economics and Psychology from The University of Hong Kong. Mr Or has worked in a variety of positions within The Hongkong and Shanghai Banking Corporation Limited in personnel, securities, retail banking and corporate banking. He was promoted to Assistant General Manager and Head of Corporate and Institutional Banking in 1995, General Manager in 2000 and a Director in 2005.

### # **Mr Edgar David ANCONA**

Mr Ancona, aged 56, is a non-executive Director of the Bank. He has been a Director of the Bank since September 2006. He is Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited and a Director of certain subsidiaries of HSBC Holdings BV, including HSBC Asia Holdings BV. He was formerly Senior Vice President Corporate Treasurer of HSBC Finance Corporation and Executive Vice President, Asset/Liability Management, of HSBC North America Holdings Inc.

Mr Ancona was educated at Rensselaer Polytechnic Institute in the US and obtained a Bachelor's degree in Science in 1974. He also obtained a Master of Science degree and a Master of Business Administration degree from the London School of Economics in 1975 and University of Chicago in 1976 respectively.

**\* Mr CHAN Cho Chak John GBS, JP**

Mr Chan, aged 65, is an independent non-executive Director and Chairman of the Remuneration Committee of the Bank. He has been a Director of the Bank since August 1995. He is non-executive Director of Transport International Holdings Limited, The Kowloon Motor Bus Company (1933) Limited and Long Win Bus Company Limited; non-executive Chairman of RoadShow Holdings Limited; and an independent non-executive Director of Guangdong Investment Limited. He is also a member of the Exchange Fund Advisory Committee of the Hong Kong Monetary Authority; Chairman of The Hong Kong Jockey Club; Chairman of the Court of the Hong Kong University of Science and Technology; Vice Patron of The Community Chest of Hong Kong; and Non-Official Member of the Commission on Strategic Development of the HKSAR Government. He was formerly an independent non-executive director of Hong Kong Exchanges and Clearing Limited from 2000 to 2003, and a former member of the Hong Kong Civil Service from 1964 to 1978 and from 1980 to 1993. Key posts in Government held by Mr Chan included Private Secretary to the Governor, Deputy Secretary (General Duties), Director of Information Services, Deputy Chief Secretary, Secretary for Trade and Industry and Secretary for Education and Manpower. Mr Chan was awarded the Gold Bauhinia Star by the HKSAR Government in July 1999.

Mr Chan graduated from The University of Hong Kong in 1964 with an Honours Degree in English Literature.

**Mr CHAN Kwok Wai Patrick**

Mr Chan, aged 52, is Executive Director and Chief Financial Officer and a Member of Executive Committee of the Bank. He has been a Director of the Bank since December 2005. He is Vice-Chairman of Hang Seng Bank (China) Limited and a Director of certain subsidiaries of the Bank, including Hang Seng Bank (Trustee) Limited, Hang Seng Insurance Company Limited, Hang Seng General Insurance (Hong Kong) Company Limited and Hang Seng Life Limited. He is also a Director, an Executive Committee member and a Remuneration Committee member of Industrial Bank Co., Ltd., PRC; a member of the Professional Development Sub-committee of the ACCA Hong Kong; a member of the Quality Education Fund Steering Committee; a member of the Protection of Wages on Insolvency Fund Board; a member of the Admissions, Budgets and Allocations Committee of The Community Chest of Hong Kong; a member of the Advisory Board on Accounting Studies of the Chinese University of Hong Kong; Honorary Vice-President of the Honorary Advisory Board of the Accounting Students' Society of the Hong Kong University of Science and Technology; Co-opted Member of Audit Committee of Urban Renewal Authority; a member of the Investment Committee of the Foundation of Tsinghua University Center for Advanced Study Co. Ltd; and a member of the HKSAR Government Scholarship Fund Investment Committee.

Mr Chan obtained a Master of Business Administration degree from the University of Warwick England in 1993. He is a Fellow Member of the Hong Kong Institute of Certified Public Accountants, and the Association of Chartered Certified Accountants. He joined the Bank as Assistant General Manager and Head of Financial Control Division in July 1995. In 1998 he took up the role of Chief Financial Officer, responsible for the planning and control of the Bank's financial direction, as well as overseeing the Bank's financial standards and discipline. In 2003, he was promoted to Deputy General Manager. He was appointed General Manager in December 2005.

Mr Chan started his career at Ernst & Young and worked for a number of banks and listed companies in Hong Kong, including Chase Manhattan Bank, Australia and New Zealand Banking Group and Dah Sing Financial Group.

**\* Dr CHENG Yu Tung GBM, DPMS, DBA(Hon), LLD(Hon), DSSc(Hon)**

Dr Cheng, aged 83, is an independent non-executive Director of the Bank. He has been a Director of the Bank since March 1985. He is Chairman of New World Development Company Limited, Chow Tai Fook Jewellery Company Limited, Melbourne Enterprises Limited and Lifestyle International Holdings Limited; and a Director of Shun Tak Holdings Limited.

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

Dr Cheung, aged 61, is an independent non-executive Director and a Member of the Audit Committee of the Bank. He has been a Director of the Bank since May 2004. He is a Non-official Member of the Executive Council; Chairman of the Airport Authority Hong Kong, the Supervisory Committee of The Tracker Fund of Hong Kong and the Council of the Hong Kong University of Science and Technology; a member of the Barristers Disciplinary Tribunal and Operations Review Committee of Independent Commission Against Corruption; and a Council Member of the Open University of Hong Kong.

Dr Cheung has been appointed an independent non-executive Director of HSBC Holdings plc with effect from 1 February 2009. He is also an independent non-executive Director of HKR International Limited, Hong Kong Exchanges and Clearing Limited and Sun Hung Kai Properties Limited; and a Director of The Association of Former Council Members of the Stock Exchange of Hong Kong Limited. Dr Cheung resigned as an independent non-executive director of Shui On Construction and Materials Limited in 2005. He was awarded the Gold Bauhinia Star by the HKSAR Government in 2008.

He is a Fellow of the Institute of Chartered Accountants in England and Wales, and the Hong Kong Institute of Certified Public Accountants. He joined KPMG Hong Kong in 1969 and was admitted into the partnership in 1974. He was elected the Chairman and Chief Executive Officer of KPMG Hong Kong from October 1996 to March 2003 and retired on 31 March 2003.

**# Mr Alexander Andrew FLOCKHART CBE**

Mr Flockhart, aged 57, is a non-executive Director of the Bank. He has been a Director of the Bank since August 2007, Director and Chief Executive Officer of The Hongkong and Shanghai Banking Corporation Limited since July 2007, and executive Director of HSBC Holdings plc since May 2008. As Group Managing Director Asia-Pacific of HSBC Holdings plc, Mr Flockhart is a member of the HSBC Group Management Board. He is also Global Head of Commercial Banking of HSBC Group; Chairman and non-executive Director of HSBC Bank Malaysia Berhad; Vice-Chairman and Director of HSBC Bank (Vietnam) Limited; a Director of HSBC Bank Australia Limited and The Shek O Development Company, Limited; and a non-executive Director of HSBC Bank (China) Company Limited.

Mr Flockhart was previously Group Managing Director Latin America from 2006 to July 2007 and Group General Manager, Chairman and Chief Executive Officer of HSBC Group in Mexico from 2002 to 2006. From December 1999 to July 2002, he was Senior Executive Vice President, Commercial Banking, HSBC Bank USA and Chairman, HSBC Bank Mexico S.A., heading the businesses of personal and commercial banking in the USA, Panama and Mexico. Before then, he had been posted to Saudi Arabia, Thailand, Hong Kong, the United Arab Emirates and Qatar.

Mr Flockhart was educated in Edinburgh, Scotland where he attended George Watson's College. He joined HSBC Group in July 1974 after graduating in law (LLB) from Edinburgh University.

In December 2007, Mr Flockhart was named a Commander of the British Empire in the Queen's New Years Honours List in recognition of his services to British business and charitable services and institutions in Mexico.

Mr Flockhart is a member of the Visa Asia Pacific Senior Advisory Council, Visa Inc and Chongqing Mayor's International Economic Advisory Council.

**\* Mr Jenkin HUI**

Mr Hui, aged 65, is an independent non-executive Director and a Member of the Remuneration Committee of the Bank. He has been a Director of the Bank since August 1994. He is a Director and Chief Executive of Point Piper Investment Limited; and a Director of Central Development Limited, Jardine Matheson Holdings Limited, Jardine Strategic Holdings Limited and Hongkong Land Holdings Limited.

**\* Mr Peter LEE Ting Chang JP**

Mr Lee, aged 55, is an independent non-executive Director and a Member of the Remuneration Committee of the Bank. He has been a Director of the Bank since August 2002 and is a Director of Barrowgate Limited. He is Chairman of Hysan Development Company Limited; independent non-executive Director of Cathay Pacific Airways Limited, CLP Holdings Limited and SCMP Group Limited;

and non-executive Director of Maersk China Limited. He is also a Vice President of the Real Estate Developers Association of Hong Kong.

Mr Lee obtained a Bachelor of Science Degree in Civil Engineering from the University of Manchester, England and qualified as a Solicitor of the Supreme Court of England and Wales.

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

Dr Li, aged 55, is an independent non-executive Director and Chairman of the Audit Committee of the Bank. He has been a Director of the Bank since February 2000. He is the senior partner of Li, Tang, Chen & Co., Certified Public Accountants, and a member of The Tenth and Eleventh National Committee of the Chinese People's Political Consultative Conference. He is also a Director of Sun Hung Kai Properties Limited, Transport International Holdings Limited, SmarTone Telecommunications Holdings Limited, Wong's International (Holdings) Limited, China Resources Enterprise, Limited, RoadShow Holdings Limited, Bank of Communications Co., Ltd. and Meadville Holdings Limited. He is also Chairman of Hong Kong Monetary Authority's Process Review Committee; a member of Basel II Consultation Group; and a Member of the Clearing and Settlement Systems Appeals Tribunal. Dr Li resigned as an independent non-executive Director of CATIC International Holdings Limited in December 2007 and retired as an independent non-executive Director of Sinofert Holdings Limited in June 2007. He was also former President of Hong Kong Society of Accountants in 1994. Dr Li was awarded the Gold Bauhinia Star by the HKSAR Government in July 2003.

Dr Li obtained a BA (Economics) Honours degree from the University of Manchester, England in 1975. He is a Fellow Member of the Hong Kong Institute of Certified Public Accountants.

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

Dr Lo, aged 60, is a non-executive Director of the Bank. He has been a Director of the Bank since February 1999. He is Chairman of Shui On Group; Chairman and Chief Executive Officer of Shui On Land Limited; Chairman of Shui On Construction and Materials Limited and China Central Properties Limited; and a non-executive Director of Great Eagle Holdings Limited. He is also a Member of The Eleventh National Committee of the Chinese People's Political Consultative Conference; Honorary Life President of Business and Professionals Federation of Hong Kong; President of Shanghai-Hong Kong Council for the Promotion and Development of Yangtze; Economic Adviser to the Chongqing Municipal Government; and Honorary Court Chairman of the Hong Kong University of Science and Technology. Dr Lo was awarded the Gold Bauhinia Star by the HKSAR Government in 1998. He was recipient of the Businessman of the Year award in the Hong Kong Business Awards 2001. Dr Lo was also awarded Director of the Year in the category of Listed Company Executive Directors by The Hong Kong Institute of Directors in 2002 and Chevalier des Arts et des Lettres by the French government in 2005. Dr Lo retired as an independent non-executive Director of China Telecom Corporation Limited in September 2008.

Dr Lo was conferred an Advisory Professorship by Shanghai Tongji University and a Doctorate in Business Administration (honoris causa) by the Hong Kong University of Science and Technology, both in 1996. He was also conferred an Advisory Professorship by Shanghai University in 1998.

**Mr POON Chung Yin Joseph**

Mr Poon, aged 54, is Managing Director and Deputy Chief Executive and a Member of the Executive Committee of the Bank. He has been a Director of the Bank since December 2004. He is an independent non-executive Director of Grandland Shipping Limited. He is also a Director of certain subsidiaries of the Bank, including Hang Seng Bank (Trustee) Limited, Hang Seng Credit Limited, Hang Seng Finance Limited, Hang Seng Insurance Company Limited and Hang Seng Life Limited. He is the Chairman of Hang Seng Index Advisory Committee of Hang Seng Indexes Company Limited and a Member of Campaign Committee of The Community Chest of Hong Kong.

After obtaining a Bachelor of Commerce degree from the University of Western Australia, Mr Poon joined Arthur Andersen & Co. in 1976 and was qualified as a Chartered Accountant in Australia. He left Arthur Andersen in 1981 to further his career in a number of internationally renowned financial institutions.

Mr Poon joined HSBC Group in 1988 as Deputy Managing Director of Wayfoong Shipping Services Limited (HSBC Group's shipping financing arm in Asia), and was appointed as Managing Director a

year later. He held a wide variety of posts and was appointed Senior Executive Commercial Banking of The Hongkong and Shanghai Banking Corporation Limited in January 2003.

**\* Dr SIN Wai Kin David DSSc(Hon)**

Dr Sin, aged 79, is an independent non-executive Director of the Bank. He has been a Director of the Bank since November 1991. He is Chairman of Myer Jewelry Manufacturer Limited, and Vice-Chairman of Miramar Hotel and Investment Company Limited. He is also Executive Director of New World Development Company Limited.

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

Mr Tang, aged 56, is an independent non-executive Director and a Member of the Audit Committee of the Bank. He has been a Director of the Bank since August 1995, and a Supervisor of Hang Seng Bank (China) Limited since May 2007. He is Chairman and Managing Director of Richcom Company Limited; Vice Chairman of King Fook Holdings Limited; and a Director of Miramar Hotel and Investment Company Limited and Hong Kong Commercial Broadcasting Company Limited. He is also Chairman of the Correctional Services Children's Education Trust Investment Advisory Board of the Correctional Services Department and Chairman of Customs & Excise Service Children's Education Trust Fund Committee; and a member of the Disciplinary Panel A of the Hong Kong Institute of Certified Public Accountants and Tang Shiu Kin and Ho Tim Charitable Fund. He was awarded "Justice of the Peace" in 1997 and the Bronze Bauhinia Star by the HKSAR Government in July 2000.

Mr Tang obtained a Bachelor of Science Degree in Business Administration from Menlo College, California, USA in 1976 and an MBA from the University of Santa Clara, California, USA in 1978.

**# Mr WONG Tung Shun Peter JP**

Mr Wong, aged 57, is a non-executive Director of the Bank. He has been a Director of the Bank since May 2005. He is Group General Manager of HSBC Holdings plc; Executive Director, Hong Kong and mainland China of The Hongkong and Shanghai Banking Corporation Limited; non-executive Director and Deputy Chairman of HSBC Bank (China) Company Limited; non-executive Director and Chairman of Hubei Suizhou Cengdu HSBC Rural Bank Company Limited, Chongqing Dazu HSBC Rural Bank Company Limited, Fujian Yong'an HSBC Rural Bank Company Limited and Beijing Miyun HSBC Rural Bank Company Limited; Director and Chairman of HSBC Insurance (Asia) Limited and HSBC Life (International) Limited. He is also non-executive Director of Bank of Communications Co., Ltd. and Ping An Insurance (Group) Company of China, Ltd.; Director of Hong Kong Interbank Clearing Limited and The Hong Kong General Chamber of Commerce; Chairman of the Hong Kong Association of Banks and President of the Hong Kong Institute of Bankers; Chairman of the Financial Services Advisory Committee of the Hong Kong Trade Development Council and The Banking Industry Training Advisory Committee; Member of the Banking Advisory Committee of the Hong Kong Monetary Authority, the 10th Hubei provincial committee of the Chinese People's Political Consultative Conference, the Board of Counsellors of the China-United States Exchange Foundation, the Aviation Development Advisory Committee and the Greater Pearl River Delta Business Council; and Honorary Professor of The University of Hong Kong.

Mr Wong was educated at Indiana University in the USA and holds Bachelor's degree in computer science, an MBA in marketing and finance and an MSc in computer science.

\* Independent non-executive Directors

# Non-executive Directors

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*Mr Alexander A Flockhart is Group Managing Director Asia-Pacific and an executive Director of HSBC Holdings plc, and a Director and the Chief Executive Officer of The Hongkong and Shanghai Banking Corporation Limited. Mr Raymond C F Or is a Director of The Hongkong and Shanghai Banking Corporation Limited. Mr Peter T S Wong is Group General Manager of HSBC Holdings plc and Executive Director, Hong Kong and mainland China of The Hongkong and Shanghai Banking Corporation Limited. Mr Edgar D Ancona is a Director of certain subsidiaries of HSBC Holdings BV, including HSBC Asia Holdings BV, and Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited. Dr Marvin K T Cheung has been appointed an independent non-executive Director of HSBC Holdings plc with effect from 1 February 2009. Each of HSBC Holdings*

*plc, HSBC Holdings BV, HSBC Asia Holdings BV and The Hongkong and Shanghai Banking Corporation Limited has an interest in the shares of the Bank as disclosed under the provisions of Divisions 2 and 3 of Part XV of the Securities and Futures Ordinance ("SFO"), the details of which are disclosed in "Substantial Interests in Share Capital" section of the Report of the Directors attached to the Bank's 2008 Annual Report.*

*The Directors' interests in shares of the Bank, if any, within the meaning of Part XV of the SFO as at 31 December 2008 are disclosed in "Directors' and Alternate Chief Executives' Interests" section of the Report of the Directors attached to the Bank's 2008 Annual Report.*

*Save as disclosed in the Directors' respective biographical details under "Biographical Details of Directors" section, the Directors (a) have not held any directorships in other publicly listed companies, whether in Hong Kong or overseas, during the last three 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.*

*The Directors (except Executive Directors) 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.*

*Commencing from 1 January 2008, no Directors' fees will be paid to Executive Directors. The salary package of an Executive Director has been determined with reference to the remuneration policy of the Bank. An Executive Director is also entitled to a discretionary bonus.*

*The details of the emoluments of the Directors on a named basis are disclosed in Note 19 of the Bank's 2008 Financial Statements.*

*None of the Directors, except Mr Patrick K W Chan, 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 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. Every retiring Director shall be eligible for re-election at the Annual General Meeting of the Bank.*

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## **BIOGRAPHICAL DETAILS OF SENIOR MANAGEMENT**

### **Mr OR Ching Fai Raymond JP**

Vice-Chairman and Chief Executive  
(Biographical details are set out on page 56)

### **Mr POON Chung Yin Joseph**

Managing Director and Deputy Chief Executive  
(Biographical details are set out on page 59)

### **Mr CHAN Kwok Wai Patrick**

Executive Director and Chief Financial Officer  
(Biographical details are set out on page 57)

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

General Manager, Personal Financial Services and Wealth Management  
Mr Leung, aged 54, joined the Bank in 1994 as Assistant General Manager and Head of Credit Card Centre. He was appointed Deputy General Manager and Deputy Head of Retail Banking in May 2000, Deputy Head of Commercial Banking in October 2003, and General Manager and Head of Wealth Management in January 2005. He has been redesignated General Manager, Personal Financial Services and Wealth Management since August 2005, responsible for the Bank's branch network and all businesses and services for personal accounts. He is a Director of HSBC Asset Management (Hong Kong) Limited; Senior Advisor of the Management Committee of Industrial Bank Co., Ltd.'s Card Centre; Chairman of the Hong Kong Creative Arts Centre Ltd.; Chairman of the Hong Kong Dance Company; Deputy Chairman of the Council of the Hong Kong Academy for Performing Arts; a member of the Hong Kong Sports Commission; a member of the Employees Retraining Board; a member of the Investor Education Advisory Committee of the Securities and Futures Commission; Chairman of the Licensing and Practice Committee of Estate Agents Authority; a member of The Banking Industry Training Advisory Committee; a member of the Advisory Committee on Disbursement of Donations of the Facility and Programme Donations Scheme; and Treasurer of Council of the Hong Kong Baptist University and Concerted Efforts Resource Centre.

### **Mrs SIT KWAN Yin Ping Dorothy**

General Manager and Chief Operating Officer  
Mrs Sit, aged 57, joined the Bank in December 2005 as General Manager. She has been appointed Chief Operating Officer since January 2006 and is responsible for overseeing the Bank's operations and processing, information technology and procedures, property and security functions. She is a non-executive Director of Hang Seng Bank (China) Limited, the mainland China subsidiary of the Bank; a member of The Banking Industry Training Advisory Committee and an Ex-officio member of its Subcommittee on Specification of Competency Standards Development. Mrs Sit was Head of Personal Financial Services, Hong Kong for The Hongkong and Shanghai Banking Corporation Limited before she joined the Bank.

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

General Manager and Head of Investment and Insurance  
Mr Fung, aged 51, joined the Bank in May 2006 as Deputy General Manager and Head of Investment and Insurance. He has been appointed General Manager and Head of Investment and Insurance since February 2008. He is responsible for overseeing the Bank's investment and insurance businesses with responsibility for management, sales and market strategy, as well as the development of new products and services. He is also a Director and General Manager of Hang Seng Investment Management Limited; a Director of Hang Seng Insurance Company Limited, Hang Seng General Insurance (Hong Kong) Company Limited, Hang Seng Life Limited, Hang Seng Investment Services Limited and Hang Seng Securities Limited; a member of the Process Review Panel for the Securities and Futures Commission; a Part-time Member of the Central Policy Unit of the HKSAR Government; a member of Council of Lingnan University; and a General Committee Member of the Federation of Hong Kong Industries. Mr Fung was Managing Director, Advisory Sales, Greater China, Global Financial Markets, of DBS Bank Ltd before he joined the Bank.



### **Mr NG Yuen Tin FHKIB**

Deputy General Manager and Head of Corporate Banking

Mr Ng, aged 57, joined the Bank in 1971. He was appointed Assistant General Manager and Deputy Head of Corporate Banking Division in January 1994 and Head of Corporate Banking Division in September 1999. He has been appointed Deputy General Manager and Head of Corporate Banking since July 2000. Mr Ng is responsible for overseeing the corporate and institutional banking business of the Bank. He is also a Director and Chief Executive of Hang Seng Finance Limited; a Director of Hang Seng Indexes Company Limited; a Director of HSI International Limited; a member of the Hang Seng Index Advisory Committee; and Honorary Treasurer of the Executive Committee of The Hong Kong Institute of Bankers.

### **Mr TAM Wai Hung David MBA, FCIB, FHKIB**

Deputy General Manager and Chief Risk Officer

Mr Tam, aged 59, joined the Bank in 1999 as Assistant General Manager and Head of Commercial Banking. He was appointed Deputy General Manager and Head of Commercial Banking in June 2003 and as Head of Commercial Banking, Greater China in January 2007. He has been appointed Chief Risk Officer of the Bank since November 2008 and is responsible for leading the Bank's overall risk management/control function. He is a Council member of Hong Kong St John Ambulance; Vice-Chairman of Executive Committee, Business and Professionals Federation of Hong Kong; and Chairman of the Council, ReSource The Counselling Centre Ltd.

### **Mr CHEUNG Tai Keung Jack**

Deputy General Manager and Head of Treasury

Mr Cheung, aged 49, joined the Bank in June 2004 as Deputy General Manager and Acting Head of Treasury. He is responsible for overseeing the Treasury and Singapore operations. He has been appointed Deputy General Manager and Head of Treasury since August 2004. Mr Cheung was Director, Head of Balance Sheet Management, Asia-Pacific Global Markets of The Hongkong and Shanghai Banking Corporation Limited before he joined the Bank.

### **Mr FU Chi King Johnson**

Deputy General Manager and Head of China Business

Mr Fu, aged 54, joined the Bank in August 2005 as Deputy General Manager and Head of China Business. He is responsible for overseeing the Bank's operations in mainland China and Taiwan, and foreign-invested, state-owned and domestic companies on the Mainland. He is also Chief Executive of Hang Seng Bank (China) Limited, the mainland China subsidiary of the Bank; and Honorable President of the Hong Kong Chamber of Commerce in China - Shanghai. Mr Fu was Regional Head of Corporate Banking, Asia Pacific and Alternate Chief Executive, Hong Kong of Commerzbank before he joined the Bank.

### **Mr CHO Tak Chi Joseph MSc, FFin, CFMP, FLMI, CIAM, ACIS**

Deputy General Manager and Head of Branch Network and Direct Banking

Mr Cho, aged 51, joined the Bank in June 1995 and served until September 1997 as Senior Retail Planning Manager. He re-joined the Bank in October 2004 as Senior Manager and Head of Customer Management and Marketing, and was appointed Assistant General Manager and Head of Branch Network and Direct Banking in May 2006. He has been appointed Deputy General Manager and Head of Branch Network and Direct Banking since February 2008 and is responsible for Branch Network and Direct Banking business of the Bank. He is also a member of the Consultative Committee on Deposit Protection Scheme of the Hong Kong Deposit Protection Board; a member of the China Development Committee of The Hong Kong Institute of Bankers; a member of the Renminbi Services Working Group and a member of Financial Service Delivery Channels Task Force of The Hong Kong Association of Banks.

## **REPORT OF THE DIRECTORS**

The Directors have pleasure in presenting their report together with the audited financial statements for the year ended 31 December 2008.

### **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 together with particulars of dividends which have been paid or declared are set out on page 72 of the Annual Report.

### **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 2008 are set out in note 37 to the financial statements for the year ended 31 December 2008.

### **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\$13.8 million.

### **Reserves**

Profit attributable to shareholders, before dividends, of HK\$14,099 million (2007: HK\$18,242 million) have been transferred to reserves. Details of the movements in reserves, including the appropriations therefrom, are set out in note 53 to the financial statements.

### **Directors**

The Directors of the Bank who were in office as at the end of the year were Dr Raymond K F Ch'ien, Mr Raymond C F Or, Mr Edgar D Ancona, Mr John C C Chan, Mr Patrick K W Chan, Dr Y T Cheng, Dr Marvin K T Cheung, Mr Alexander A Flockhart, Mr Jenkin Hui, Mr Peter T C Lee, Dr Eric K C Li, Dr Vincent H S Lo, Mr Joseph C Y Poon, Dr David W K Sin, Mr Richard Y S Tang and Mr Peter T S Wong.

The Directors retiring by rotation in accordance with the Bank's Articles of Association are Mr Raymond C F Or, Mr Patrick K W Chan, Mr Peter T C Lee, Mr Richard Y S Tang and Mr Peter T S Wong. Mr Raymond C F Or has informed the Board of his intention of not seeking re-election at the Bank's Annual General Meeting to be held on 6 May 2009 (the "2009 AGM") for the reason set out below. All the other above mentioned Directors will offer themselves for re-election at the 2009 AGM.

Mr Raymond C F Or will retire as Vice-Chairman and Chief Executive of the Bank and from the Board with effect from the conclusion of the 2009 AGM. Mrs Margaret K M Y Leung will be appointed a non-executive Director of the Bank with effect from 1 April 2009 until the conclusion of the 2009 AGM and being eligible, will offer herself for election by shareholders at the 2009 AGM. Subject to being elected by the shareholders and upon Mr Or's retirement as aforesaid, Mrs Leung will become Vice-Chairman and Chief Executive of the Bank with effect from the conclusion of the 2009 AGM.

Apart from the aforesaid prospective changes to the Board composition, Dr Y T Cheng and Dr David W K Sin have also tendered their resignation from the Board with effect from the conclusion of the 2009 AGM in order to devote more time to their own businesses.

The Board announces the above changes to the Board composition on 2 March 2009. For further details of the above changes to Board composition, shareholders may refer to the announcement issued by the Bank and uploaded on the Bank's website at [www.hangseng.com](http://www.hangseng.com).

No Director proposed for re-election at the forthcoming Annual General Meeting 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 2008, 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>						
<b>Directors:</b>						
Mr Raymond C F Or	50,000	-	-	-	50,000	0.00
Mr John C C Chan	-	-	-	1,000 <sup>(1)</sup>	1,000	0.00
Mr Patrick K W Chan	-	1,000	-	-	1,000	0.00
Mr Joseph C Y Poon	5,000	10,000	-	-	15,000	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
<b>Number of Ordinary Shares of US\$0.50 each in HSBC Holdings plc</b>						
<u>Directors:</u>						
Dr Raymond K F Ch'ien	57,704	-	-	-	57,704	0.00
Mr Raymond C F Or	235,408	40,878	-	156,671 <sup>(6)</sup>	432,957	0.00
Mr Edgar D Ancona	253,195	-	-	499,504 <sup>(6)</sup>	752,699	0.01
Mr John C C Chan	14,283	-	-	3,000 <sup>(1)</sup>	17,283	0.00
Mr Patrick K W Chan	8,091	5,563	-	63,377 <sup>(6)</sup>	77,031	0.00
Mr Alexander A Flockhart	172,583	-	-	385,976 <sup>(6)</sup>	558,559	0.00
Mr Jenkin Hui	11,627	24,342	1,288,422 <sup>(2)</sup>	-	1,324,391	0.01
Dr Eric K C Li	-	18,132	79,622 <sup>(3)</sup>	-	97,754	0.00
Mr Joseph C Y Poon	24,304 <sup>(4)</sup>	66,314	-	55,886 <sup>(6)</sup>	146,504	0.00
Mr Peter T S Wong	131,786	23,164	-	142,171 <sup>(6)</sup>	297,121	0.00
<u>Alternate Chief Executives:</u>						
Mr William W Leung	19,740	-	-	47,673 <sup>(6)</sup>	67,413	0.00
Mrs Dorothy K Y P Sit	18,834 <sup>(5)</sup>	728	-	39,418 <sup>(6)</sup>	58,980	0.00

Notes:

- (1) 1,000 shares in the Bank and 3,000 shares in HSBC Holdings plc were held by a trust of which Mr and Mrs John C C Chan 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) Dr Eric K C Li was entitled to control no less than one-third of the voting power at general meetings of a private company which beneficially held all of those shares referred to above as his corporate interests.
- (4) 22,599 shares were jointly held by Mr and Mrs Joseph C Y Poon.
- (5) 5,680 shares were jointly held by Mrs Dorothy K Y P Sit and her husband.
- (6) These represented interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans/HSBC Finance 1996 Long-Term Executive Incentive Compensation Plan to acquire ordinary shares of US\$0.50 each in HSBC Holdings plc and (ii) conditional awards of shares under the HSBC Share Plans made in favour of Directors and Alternate Chief Executives and held by various trusts for ordinary shares of US\$0.50 each in HSBC Holdings plc, 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
<i>Directors:</i>			
Mr Raymond C F Or	2,504	154,167	156,671
Mr Edgar D Ancona	394,913	104,591	499,504
Mr Patrick K W Chan	28,203	35,174	63,377
Mr Alexander A Flockhart	1,332	384,644	385,976
Mr Joseph C Y Poon	14,704	41,182	55,886
Mr Peter T S Wong	-	142,171	142,171
<i>Alternate Chief Executives:</i>			
Mr William W Leung	12,500	35,173	47,673
Mrs Dorothy K Y P Sit	5,435	33,983	39,418

### Options

As at 31 December 2008, 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 2008	Options exercised during the year (ordinary shares of US\$0.50 each)	Exercise price per share	Date granted	Exercisable from	Exercisable until
<i>Directors:</i>						
Mr Raymond C F Or	1,515	-	£6.4720	10 May 2004	1 Aug 2009	31 Jan 2010
	989	-	£6.6792	24 May 2005	1 Aug 2010	31 Jan 2011
	2,504					
Mr Edgar D Ancona	-	64,200 <sup>(1)&amp;(2)</sup>	US\$13.7100	9 Nov 1998	9 Nov 1999	9 Nov 2008
	80,250 <sup>(1)</sup>	-	US\$16.9600	8 Nov 1999	8 Nov 2000	8 Nov 2009
	85,600 <sup>(1)</sup>	-	US\$18.4000	13 Nov 2000	13 Nov 2001	13 Nov 2010
	93,625 <sup>(1)</sup>	-	US\$21.3700	12 Nov 2001	12 Nov 2002	12 Nov 2011
	33,438 <sup>(1)</sup>	-	US\$10.6600	20 Nov 2002	20 Nov 2003	20 Nov 2012
	51,000	-	£9.1350	3 Nov 2003	3 Nov 2006	3 Nov 2013
	51,000	-	£8.2830	30 Apr 2004	30 Apr 2007	30 Apr 2014
	394,913					
Mr Patrick K W Chan	6,500	-	£7.4600	3 Apr 2000	3 Apr 2003	2 Apr 2010
	6,000	-	£8.7120	23 Apr 2001	23 Apr 2004	22 Apr 2011
	6,500	-	£8.4050	7 May 2002	7 May 2005	6 May 2012
	7,000	-	£6.9100	2 May 2003	2 May 2006	1 May 2013
	2,203 <sup>(3)</sup>	-	HK\$108.4483	25 Apr 2007	1 Aug 2012	31 Jan 2013
	28,203					

	Options held as at 31 December 2008	Options exercised during the year (ordinary shares of US\$0.50 each)	Exercise price per share	Date granted	Exercisable from	Exercisable until
Mr Alexander	-	22,500 <sup>(4)</sup>	£6.2767	16 Mar 1998	16 Mar 2001	16 Mar 2008
A Flockhart	1,332	-	£7.0872	25 Apr 2007	1 Aug 2010	31 Jan 2011
	<u>1,332</u>					
Mr Joseph C	-	9,000 <sup>(5)</sup>	£6.3754	29 Mar 1999	29 Mar 2002	29 Mar 2009
Y Poon	-	4,750 <sup>(5)</sup>	£7.4600	3 Apr 2000	3 Apr 2003	3 Apr 2010
	2,750	-	£8.7120	23 Apr 2001	23 Apr 2004	23 Apr 2011
	4,400	-	£8.4050	7 May 2002	7 May 2005	7 May 2012
	5,050	-	£6.9100	2 May 2003	2 May 2006	2 May 2013
	1,515	-	£6.4720	10 May 2004	1 Aug 2009	31 Jan 2010
	989	-	£6.6792	24 May 2005	1 Aug 2010	31 Jan 2011
	<u>14,704</u>					
<u>Alternate Chief Executives:</u>						
Mr William W	6,000	-	£6.9100	2 May 2003	2 May 2006	1 May 2013
Leung	6,500	-	£8.2830	30 Apr 2004	30 Apr 2007	29 Apr 2014
	<u>12,500</u>					
Mrs Dorothy	3,000	-	£8.7120	23 Apr 2001	23 Apr 2004	22 Apr 2011
K Y P Sit	2,435	-	£6.6792	24 May 2005	1 Aug 2010	31 Jan 2011
	<u>5,435</u>					

Notes:

- (1) These represented Mr Edgar D Ancona's interests in options under HSBC Finance 1996 Long-Term Executive Incentive Compensation Plan. These options arise from options he held over shares of Household International, Inc. (now HSBC Finance Corporation) before its acquisition, which were converted into options over HSBC Holdings plc ordinary shares in the same ratio as the offer for HSBC Finance Corporation and the exercise prices per share adjusted accordingly. These options were granted at nil consideration.
- (2) As at the date of exercise, 26 September 2008, the market value per share was £8.7900.
- (3) Notification that Mr Patrick K W Chan held these unlisted physically settled options to acquire shares of US\$0.50 each in HSBC Holdings plc was given by him in January 2009 on his becoming aware of the same.
- (4) As at the date of exercise, 4 March 2008, the market value per share was £7.6900.
- (5) As at the date of exercise, 15 May 2008, the market value per share was £8.9200.

Conditional awards of shares

As at 31 December 2008, the interests of the Directors and Alternate Chief Executives in the conditional awards of shares made in favour of them under the HSBC Share Plans and held by various trusts for ordinary shares of US\$0.50 each in HSBC Holdings plc were as follows:

	Awards held as at 1 January 2008	Awards made during the year	Shares awarded released during the year	Awards held as at 31 December 2008
<u>Directors:</u>				
Mr Raymond C F Or	198,569	62,060	35,587	154,167 <sup>(1)&amp;(2)</sup>
Mr Edgar D Ancona	103,733	33,333	38,327	104,591 <sup>(1)</sup>
Mr Patrick K W Chan	26,511	12,425	5,445	35,174 <sup>(1)</sup>
Mr Alexander A Flockhart	322,411	139,103	33,573	384,644 <sup>(1)&amp;(2)</sup>
Mr Joseph C Y Poon	38,100	14,545	6,836	41,182 <sup>(1)&amp;(2)</sup>
Mr Peter T S Wong	82,700	52,261	-	142,171 <sup>(1)</sup>
<u>Alternate Chief Executives:</u>				
Mr William W Leung	34,469	12,425	6,836	35,173 <sup>(1)&amp;(2)</sup>
Mrs Dorothy K Y P Sit	42,911	12,121	6,836	33,983 <sup>(1)&amp;(2)</sup>

Notes:

(1) This includes additional shares arising from scrip dividends.

(2) This takes into account the forfeiture of shares under the relevant Share Plan(s).

All the interests stated above represent long positions. As at 31 December 2008, 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 2008.

### 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 end of the year, 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 Group Managing Director Asia-Pacific and an executive Director of HSBC Holdings plc, a Director and the Chief Executive Officer of The Hongkong and Shanghai Banking Corporation Limited and Global Head of Commercial Banking of HSBC Group. He is also the Chairman and a non-executive Director of HSBC Bank Malaysia Berhad, Vice-Chairman and a Director of HSBC Bank (Vietnam) Limited, a Director of HSBC Bank Australia Limited and a non-executive Director of HSBC Bank (China) Company Limited.

Mr Raymond C F Or is a Director of The Hongkong and Shanghai Banking Corporation Limited.

Mr Edgar D Ancona is the Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited. He is also a Director of certain subsidiaries of HSBC Holdings BV, including HSBC Asia Holdings BV, the immediate holding company of The Hongkong and Shanghai Banking Corporation Limited.

Mr Patrick K W Chan is a Director, an Executive Committee member and a Remuneration Committee member of Industrial Bank Co., Ltd (“Industrial Bank”), in which the Bank holds a 12.78% stake. Industrial Bank conducts general banking business in mainland China.

Mr Peter T S Wong is Group General Manager of HSBC Holdings plc and Executive Director, Hong Kong and mainland China of The Hongkong and Shanghai Banking Corporation Limited. He is a Director and Chairman of HSBC Insurance (Asia) Limited and HSBC Life (International) Limited, non-executive Director and Deputy Chairman of HSBC Bank (China) Company Limited and non-executive Director and Chairman of Hubei Suizhou Cengdu HSBC Rural Bank Company Limited, Chongqing Dazu HSBC Rural Bank Company Limited, Fujian Yongan HSBC Rural Bank Company Limited and Beijing Miyun HSBC Rural Bank Company Limited, all being subsidiaries of The Hongkong and Shanghai Banking Corporation 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, Industrial 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 Industrial Bank as required by the laws of mainland China. All members of Industrial Bank’s Audit and Related Party Transactions Control Committee are independent non-executive Directors.

The Board of the Bank includes nine 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 2008.

## Substantial Interests In Share Capital

The register maintained by the Bank pursuant to the SFO recorded that, as at 31 December 2008, 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 (formerly known as “HSBC Asia Holdings (UK)”), 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 2008, 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, 2 March 2009

## CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2008

(Expressed in millions of Hong Kong dollars)

		2008	2007
	note		
Interest income	8	26,172	34,406
Interest expense	8	(9,940)	(19,687)
<b>Net interest income</b>		<b>16,232</b>	<b>14,719</b>
Fee income		5,704	7,682
Fee expense		(735)	(796)
<b>Net fee income</b>	9	<b>4,969</b>	<b>6,886</b>
Trading income	10	1,455	1,679
Net (loss)/income from financial instruments designated at fair value	11	(1,031)	1,907
Dividend income	12	82	52
Net earned insurance premiums	13	12,351	9,702
Other operating income	14	701	747
<b>Total operating income</b>		<b>34,759</b>	<b>35,692</b>
Net insurance claims incurred and movement in policyholders' liabilities	15	(11,463)	(10,677)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>		<b>23,296</b>	<b>25,015</b>
Loan impairment charges and other credit risk provisions	16	(2,776)	(576)
<b>Net operating income</b>		<b>20,520</b>	<b>24,439</b>
Employee compensation and benefits		(3,452)	(3,585)
General and administrative expenses		(2,851)	(2,684)
Depreciation of premises, plant and equipment		(432)	(348)
Amortisation of intangible assets		(60)	(33)
<b>Total operating expenses</b>	17	<b>(6,795)</b>	<b>(6,650)</b>
<b>Operating profit</b>		<b>13,725</b>	<b>17,789</b>
Gain on dilution of investment in associate		-	1,465
Gains less losses from financial investments and fixed assets	21	267	716
Net surplus on property revaluation	22	79	379
Share of profits from associates		1,807	1,122
<b>Profit before tax</b>		<b>15,878</b>	<b>21,471</b>
Tax expense	23	(1,779)	(2,865)
<b>Profit for the year</b>		<b>14,099</b>	<b>18,606</b>
Profit attributable to shareholders		14,099	18,242
Profit attributable to minority interests		-	364
		<b>14,099</b>	<b>18,606</b>
Dividends	26	12,045	12,045
<i>(Figures in HK\$)</i>			
Earnings per share	25	7.37	9.54
Dividends per share	26	6.30	6.30

The notes on pages 77 to 220 form part of these financial statements.

## CONSOLIDATED BALANCE SHEET

at 31 December 2008

(Expressed in millions of Hong Kong dollars)

	note	2008	2007
<b>ASSETS</b>			
Cash and balances with banks and other financial institutions	30	24,822	16,864
Placings with and advances to banks and other financial institutions	31	69,579	113,029
Trading assets	32	108,389	10,390
Financial assets designated at fair value	33	7,798	13,892
Derivative financial instruments	34	7,104	4,702
Advances to customers	35	329,121	308,356
Financial investments	36	181,159	244,294
Investments in associates	38	8,870	6,177
Investment properties	39	2,593	2,581
Premises, plant and equipment	40	7,090	6,794
Interest in leasehold land held for own use under operating lease	41	551	565
Intangible assets	42	3,385	2,889
Other assets	43	11,506	15,465
Deferred tax assets	50	201	1
		<u>762,168</u>	<u>745,999</u>
<b>LIABILITIES</b>			
Current, savings and other deposit accounts	44	562,183	546,653
Deposits from banks		11,556	19,736
Trading liabilities	45	48,282	48,151
Financial liabilities designated at fair value	46	1,407	1,498
Derivative financial instruments	34	14,945	4,683
Certificates of deposit and other debt securities in issue	47	2,772	5,685
Other liabilities	48	15,448	17,850
Liabilities to customers under insurance contracts	49	43,835	33,089
Current tax liabilities	50	94	1,479
Deferred tax liabilities	50	711	1,365
Subordinated liabilities	51	9,309	9,354
		<u>710,542</u>	<u>689,543</u>
<b>CAPITAL RESOURCES</b>			
Share capital	52	9,559	9,559
Retained profits	53	32,518	32,873
Other reserves	53	3,813	8,288
Proposed dividends	26	5,736	5,736
Shareholders' funds		<u>51,626</u>	<u>56,456</u>
		<u>762,168</u>	<u>745,999</u>

**Raymond K F Ch'ien** *Chairman*

**Raymond C F Or** *Vice-Chairman and Chief Executive*

**Patrick K W Chan** *Executive Director and Chief Financial Officer*

**C C Li** *Secretary*

The notes on pages 77 to 220 form part of these financial statements.

## BALANCE SHEET

at 31 December 2008

(Expressed in millions of Hong Kong dollars)

	note	2008	2007
<b>ASSETS</b>			
Cash and balances with banks and other financial institutions	30	22,071	13,362
Placings with and advances to banks and other financial institutions	31	38,097	86,137
Trading assets	32	107,775	8,904
Financial assets designated at fair value	33	830	1,238
Derivative financial instruments	34	6,910	4,411
Advances to customers	35	280,255	255,413
Amounts due from subsidiaries		84,907	102,806
Financial investments	36	112,000	172,599
Investments in subsidiaries	37	11,284	11,284
Investments in associates	38	2,543	1,634
Investment properties	39	1,714	1,708
Premises, plant and equipment	40	4,294	4,127
Interest in leasehold land held for own use under operating lease	41	551	565
Intangible assets	42	342	234
Other assets	43	8,872	13,262
Deferred tax assets	50	187	-
		<u>682,632</u>	<u>677,684</u>
<b>LIABILITIES</b>			
Current, savings and other deposit accounts	44	547,385	533,330
Deposits from banks		8,263	12,593
Trading liabilities	45	43,467	47,150
Financial liabilities designated at fair value	46	994	989
Derivative financial instruments	34	14,938	4,431
Certificates of deposit and other debt securities in issue	47	2,772	7,203
Amounts due to subsidiaries		8,575	5,365
Other liabilities	48	14,810	17,821
Current tax liabilities	50	66	1,332
Deferred tax liabilities	50	-	649
Subordinated liabilities	51	9,309	9,354
		<u>650,579</u>	<u>640,217</u>
<b>CAPITAL RESOURCES</b>			
Share capital	52	9,559	9,559
Retained profits	53	15,563	19,211
Other reserves	53	1,195	2,961
Proposed dividends	26	5,736	5,736
Shareholders' funds		<u>32,053</u>	<u>37,467</u>
		<u>682,632</u>	<u>677,684</u>

**Raymond K F Ch'ien** *Chairman*

**Raymond C F Or** *Vice-Chairman and Chief Executive*

**Patrick K W Chan** *Executive Director and Chief Financial Officer*

**C C Li** *Secretary*

The notes on pages 77 to 220 form part of these financial statements.

## CONSOLIDATED STATEMENT OF RECOGNISED INCOME AND EXPENSE

for the year ended 31 December 2008

(Expressed in millions of Hong Kong dollars)

	2008	2007
Unrealised surplus on revaluation of premises, net of tax	143	443
Tax on realisation of revaluation surplus on disposal of premises	4	45
Available-for-sale investments reserve, net of tax:		
- fair value changes taken to equity:		
-- on debt securities	(3,367)	(429)
-- on equity shares	(1,905)	2,023
- fair value changes transferred to income statement:		
-- on impairment	543	-
-- on hedged items	(418)	(181)
-- on disposal	(568)	(444)
Cash flow hedges reserve, net of tax:		
- fair value changes taken to equity	735	146
- fair value changes transferred to income statement	(317)	218
Actuarial losses on defined benefit plans, net of tax	(2,518)	(1,243)
Exchange differences on translation of financial statements		
of overseas branches, subsidiaries and associates	627	527
Effect of decrease in tax rate on deferred tax balance at 1 January	30	-
Net (expense)/income recognised directly in equity	(7,011)	1,105
Profit for the year	14,099	18,606
Total recognised income and expense for the year	<u>7,088</u>	<u>19,711</u>
Attributable to shareholders	7,088	19,347
Attributable to minority interests	-	364
	<u>7,088</u>	<u>19,711</u>

## CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2008

(Expressed in millions of Hong Kong dollars)

	note	2008	2007
<b>Net cash (outflow)/inflow from operating activities</b>	54(a)	<b>(86,830)</b>	21,070
<b>Cash flows from investing activities</b>			
Dividends received from associates		287	207
Purchase of an interest in associate		(909)	-
Purchase of available-for-sale investments		(79,103)	(90,693)
Purchase of held-to-maturity debt securities		(198)	(504)
Proceeds from sale or redemption of available-for-sale investments		136,534	91,813
Proceeds from redemption of held-to-maturity debt securities		123	43
Purchase of fixed assets and intangible assets		(666)	(540)
Proceeds from sale of fixed assets and assets held for sale		272	1,130
Interest received from available-for-sale investments		8,188	9,756
Dividends received from available-for-sale investments		80	49
Net cash outflow from increase in stake of subsidiaries		-	(2,409)
Net cash inflow from investing activities		<b>64,608</b>	8,852
<b>Cash flows from financing activities</b>			
Dividends paid		(12,045)	(9,942)
Interest paid for subordinated liabilities		(396)	(473)
Proceeds from subordinated liabilities		-	2,342
Net cash outflow from financing activities		<b>(12,441)</b>	<b>(8,073)</b>
<b>(Decrease)/increase in cash and cash equivalents</b>		<b>(34,663)</b>	21,849
<b>Cash and cash equivalents at 1 January</b>		<b>113,474</b>	90,275
Effect of foreign exchange rate changes		<b>(2,695)</b>	1,350
<b>Cash and cash equivalents at 31 December</b>	54(b)	<b><u>76,116</u></b>	<b><u>113,474</u></b>

The notes on pages 77 to 220 form part of these financial statements.

## NOTES TO THE FINANCIAL STATEMENTS

year ended 31 December 2008

(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));
- 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 estimates with a significant risk of material adjustment in next year are discussed in note 6.

Disclosures under HKFRS4 "Insurance Contract" and HKFRS7 "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 recognized when the shareholder's right to receive payment is established. Dividend income from listed investments is recognized 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 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**

Segmental information is presented in respect of business and geographical segments. Business by customer group information, which is more relevant to the Group in making operating and financial decisions, is chosen as the primary reporting format.

## **(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 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;
- 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;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;

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

- 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 balance sheet 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 balance sheet date 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)*

### **(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 class 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.

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". This includes the amount of change, during the period and cumulatively, in the fair value of designated financial liabilities and loans and receivables that is attributable to changes in their credit risk, i.e. the amount of change in fair value that is not attributable to changes in market interest rates. 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".

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

### *(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 equity in the "Available-for-sale investments reserve" until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as "Gains less losses from financial investments 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 hedges"). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value or cash flow hedges provided certain criteria are met.

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.

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

### *(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 hedges*

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

For cash flow hedges of a recognised asset or liability, the associated cumulative gain or loss is recycled from equity and recognised in 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 existing in equity 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 reported in equity is immediately transferred 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.

All gains and losses from changes in the fair value of any derivatives held for trading and those that do not qualify for hedge accounting are recognised immediately in the income statement and reported in "Trading income". For derivative contracts which are used with financial instruments designated at fair value, the 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 balance sheet 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 balance sheet and the consideration paid is recorded in "Placings 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.

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

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

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

### **(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 balance sheet date, 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 balance sheet date applicable for an instrument with similar terms and conditions. Where other pricing models are used, inputs are based on market data at the balance sheet date. 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 balance sheet, 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.

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 for the year, together with any impairment loss on goodwill relating to the investment in associate recognised for the year.

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 balance sheet, investment in associate is stated at cost less impairment allowances.

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

### **(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 balance sheet. 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 balance sheet 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 balance sheet 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 balance sheet date.

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 "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

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

- 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 balance sheet 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 balance sheet 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.

#### *(ii) Operating leases*

Where the Group leases out assets under operating leases, the assets are included in the balance sheet 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 each balance sheet date 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.



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

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

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

Impairment losses 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 directly in equity. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value;

– For an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in equity. Impairment losses recognised on 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 each balance sheet date 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:

- 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.

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

### *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 directly in equity, in which case they are recognised in equity. 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 balance sheet date, 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.

The carrying amount of deferred tax assets/ liabilities is reviewed at each balance sheet date 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.

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

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 Recognised Income and Expense 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 balance sheet date 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.

### **(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 balance sheet date. 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 accounted for in a separate foreign exchange reserve in equity. 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 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.

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

### **(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 balance sheet date 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.

#### ***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 balance sheet date, 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 balance sheet date, 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 balance sheet date.

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

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 and 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 balance sheet.

### **(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 balance sheet.

### **(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.

### **(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 balance sheet date are disclosed as a separate component of shareholders' equity.

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

### 5. Changes in accounting policies

The HKICPA has issued a number of new and revised HKFRSs and Interpretations that are first effective or available for early adoption for the current accounting period of the Group and the Bank. There have been no significant changes to the accounting policies applied in these financial statements for the years presented as a result of these developments.

Hong Kong (IFRIC) Interpretation 11 "Group and Treasury Share Transactions" ("HK(IFRIC) - Int 11") is effective for annual periods beginning on or after 1 March 2007. On application of this interpretation, with effect from 1 January 2008, the Group has recognised all share-based payment transactions as equity-settled, whereby the fair value of the awards at grant date is recognised in "Other reserves" under shareholders' equity. Previously, certain share-based payment transactions involving principally achievement and restricted share awards were recognised as cash-settled transactions, whereby a liability was recognised in respect of the fair value of such awards at each reporting date. The effect of the adoption of HK(IFRIC) - Int 11 was not considered to be material for the Group and therefore, the prior year figures have not been restated.

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

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

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

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (see note 7).

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### 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 4n 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.

-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.

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

#### *(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.

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

### **7. Possible impact of amendments, new standards and interpretations issued but not yet effective for the year ended 31 December 2008**

The HKICPA has issued a number of amendments to HKFRS and Interpretations which are not yet effective for the year ended 31 December 2008 and which have not been adopted in these financial statements.

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

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

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

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

A revised HKFRS 3 "Business Combinations" and an amended HKAS27 "Consolidated and Separate Financial Statements" were issued by the HKICPA in March 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes are that:

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

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

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



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

The HKICPA issued amendments to HKAS32 “Financial Instruments: Presentation” and HKAS1 “Presentation of Financial Statements” - “Puttable Financial Instruments and Obligations Arising on Liquidation”, in June 2008. The amendments are applicable for annual periods beginning on or after 1 January 2009. The Group is currently assessing the effect of the amendments on the consolidated financial statements.

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

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

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

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

The HKICPA issued an amendment to 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. The Group is currently assessing the effect of the amendment on the consolidated financial statements.

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

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

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

### 8 Interest income/interest expense

#### (a) Interest income

	2008	2007
Interest income arising from:		
- financial assets that are not at fair value through profit or loss	25,599	33,701
- trading assets	363	591
- financial assets designated at fair value	210	114
	<u>26,172</u>	<u>34,406</u>
of which:		
- interest income from listed investments	3,204	4,384
- interest income from unlisted investments	5,701	8,451
- interest income from impaired financial assets	18	32

#### (b) Interest expense

	2008	2007
Interest expense arising from:		
- financial liabilities that are not at fair value through profit or loss	8,322	17,297
- trading liabilities	1,574	2,344
- financial liabilities designated at fair value	44	46
	<u>9,940</u>	<u>19,687</u>
of which:		
- interest expense from debt securities in issue maturing after five years	11	50
- interest expense from customer accounts maturing after five years	1	29
- interest expense from subordinated liabilities	396	500

### 9 Net fee income

	2008	2007
- stockbroking and related services	1,359	1,985
- retail investment funds	1,084	1,676
- structured investment products	341	661
- insurance	98	115
- account services	282	284
- private banking	234	1,000
- remittances	212	193
- cards	1,304	1,048
- credit facilities	132	110
- trade services	409	406
- other	249	204
Fee income	5,704	7,682
Fee expense	(735)	(796)
	<u>4,969</u>	<u>6,886</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	1,586	1,454
- fee income	2,124	1,843
- fee expense	(538)	(389)
Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers	620	1,297
- fee income	773	1,449
- fee expense	(153)	(152)

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 10 Trading income

	2008	2007
Foreign exchange	1,384	861
Gains/(losses) from hedging activities:		
- fair value hedge		
-- on hedging instruments	(515)	(197)
-- on the hedged items attributable to the hedged risk	496	214
- cash flow hedges		
-- net hedging income	1	-
Securities, derivatives and other trading activities	89	801
	<u>1,455</u>	<u>1,679</u>

### 11 Net (loss)/income from financial instruments designated at fair value

	2008	2007
Net (loss)/income on assets designated at fair value which back insurance and investment contracts	(1,045)	1,903
Net change in fair value of other financial instruments designated at fair value	14	4
	<u>(1,031)</u>	<u>1,907</u>
of which dividend income from:		
- listed investments	35	47
- unlisted investments	1	5
	<u>36</u>	<u>52</u>

### 12 Dividend income

	2008	2007
Dividend income:		
- listed investments	66	47
- unlisted investments	16	5
	<u>82</u>	<u>52</u>

### 13 Net earned insurance premiums

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
<b>2008</b>				
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>328</u>	<u>11,977</u>	<u>46</u>	<u>12,351</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 13 Net earned insurance premiums (continued)

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2007				
Gross written premiums	400	9,375	54	9,829
Movement in unearned premiums	(14)	-	-	(14)
Gross earned premiums	<u>386</u>	<u>9,375</u>	<u>54</u>	<u>9,815</u>
Gross written premiums ceded to reinsurers	(76)	(35)	-	(111)
Reinsurers' share of movement in unearned premiums	(2)	-	-	(2)
Reinsurers' share of gross earned premiums	<u>(78)</u>	<u>(35)</u>	<u>-</u>	<u>(113)</u>
Net earned insurance premiums	<u><u>308</u></u>	<u><u>9,340</u></u>	<u><u>54</u></u>	<u><u>9,702</u></u>

### 14 Other operating income

	2008	2007
Rental income from investment properties	138	139
Movement in present value of in-force long-term insurance business	382	397
Other	181	211
	<u>701</u>	<u>747</u>

### 15 Net insurance claims incurred and movement in policyholders' liabilities

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
<b>2008</b>				
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>
<b>2007</b>				
Claims, benefits and surrenders paid	97	566	43	706
Movement in provisions	(1)	9,945	46	9,990
Gross claims incurred and movement in policyholders' liabilities	96	10,511	89	10,696
Reinsurers' share of claims, benefits and surrenders paid	(12)	(10)	-	(22)
Reinsurers' share of movement in provisions	11	(8)	-	3
Reinsurers' share of claims incurred and movement in policyholders' liabilities	<u>(1)</u>	<u>(18)</u>	<u>-</u>	<u>(19)</u>
Net insurance claims incurred and movement in policyholders' liabilities	<u><u>95</u></u>	<u><u>10,493</u></u>	<u><u>89</u></u>	<u><u>10,677</u></u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 16 Loan impairment charges and other credit risk provisions

	Group		Bank	
	2008	2007	2008	2007
Loan impairment charges (note 35(b)):				
- individually assessed	(925)	(250)	(808)	(255)
- collectively assessed	(476)	(326)	(378)	(332)
	<u>(1,401)</u>	<u>(576)</u>	<u>(1,186)</u>	<u>(587)</u>
of which:				
- new and additional	(1,505)	(702)	(1,272)	(686)
- releases	48	64	43	50
- recoveries	56	62	43	49
	<u>(1,401)</u>	<u>(576)</u>	<u>(1,186)</u>	<u>(587)</u>
Other credit risk provisions	(1,375)	-	(846)	-
	<u>(2,776)</u>	<u>(576)</u>	<u>(2,032)</u>	<u>(587)</u>

Impairment charge of HK\$1,375 million and HK\$846 million were provided for certain available-for-sale debt securities of the Group and the Bank respectively (2007: Nil) while there was no impairment loss made in relation to held-to-maturity investments in 2008 (2007: Nil).

### 17 Operating expenses

	2008	2007
Employee compensation and benefits:		
- salaries and other costs	2,817	2,443
- performance-related pay*	462	1,095
- retirement benefit costs		
-- defined benefit scheme (note 59(a))	104	(9)
-- defined contribution scheme (note 59(b))	69	56
	<u>3,452</u>	<u>3,585</u>
General and administrative expenses:		
- rental expenses	409	364
- amortisation of prepaid operating lease payment (note 41)	14	15
- other premises and equipment	926	820
- marketing and advertising expenses	516	601
- other operating expenses	986	884
	<u>2,851</u>	<u>2,684</u>
Depreciation of business premises and equipment (note 40(a))	432	348
Amortisation of intangible assets (note 42(c))	60	33
	<u>6,795</u>	<u>6,650</u>
* of which:		
share based payments (note 60(e))	109	88
Cost efficiency ratio	29.2%	26.6%

Included in operating expenses are minimum lease payments under operating leases of HK\$437 million (2007: HK\$467 million).

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

**18 The emoluments of the five highest paid individuals**

**(a) The aggregate emoluments**

	<b>2008</b>	2007
Salaries, allowances and benefits in kind	<b>22</b>	21
Retirement scheme contributions	<b>3</b>	3
Discretionary bonuses	<b>18</b>	12
Share-based payments	<b>8</b>	3
	<u><b>51</b></u>	<u>39</u>

**(b) The numbers of the five highest paid individuals whose emoluments fell within the following bands were:**

HK\$	<b>2008</b> <b>Number of</b> <b>Individuals</b>	2007 Number of Individuals
4,500,001 - 5,000,000	-	1
5,000,001 - 5,500,000	-	1
6,000,001 - 6,500,000	-	1
6,500,001 - 7,000,000	<b>1</b>	-
7,000,001 - 7,500,000	-	1
7,500,001 - 8,000,000	<b>2</b>	-
9,000,001 - 9,500,000	<b>1</b>	-
14,500,001 - 15,000,000	-	1
19,500,001 - 20,000,000	<b>1</b>	-
	<u><b>5</b></u>	<u>5</u>

The emoluments of the five highest paid individuals set out above include the emoluments of three (2007: three) Executive Directors. 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>(5)</sup> '000	Discretionary bonuses '000	Share-based payments <sup>(6)</sup> '000	Total 2008 '000	Total 2007 '000
<b>Executive Directors</b>							
Mr Raymond C F Or	- <sup>(1)</sup>	7,759	975	7,415	3,497	19,646	14,958
Mr Joseph C Y Poon	- <sup>(2)</sup>	3,818	405	3,746	1,116	9,085	7,259
Mr Patrick K W Chan	- <sup>(2)</sup>	3,554	299	1,876	1,258	6,987	4,784
<b>Non-Executive Directors</b>							
Mr Raymond K F Ch'ien <sup>(4)</sup> (Appointed on 6 Aug 07)	360	-	-	-	-	360	96
Mr M R P Smith (Resigned on 15 Jun 07)	- <sup>(3)</sup>	-	-	-	-	-	115
Mr Edgar David Ancona	280 <sup>(3)</sup>	-	-	-	-	280	150
Mr Alexander A Flockhart (Appointed on 6 Aug 07)	280 <sup>(3)</sup>	-	-	-	-	280	63
Mr John C C Chan <sup>(4)</sup>	340	-	-	-	-	340	210
Dr Y T Cheng <sup>(4)</sup>	280	-	-	-	-	280	150
Dr Marvin K T Cheung <sup>(4)</sup>	360	-	-	-	-	360	230
Mr Jenkin Hui <sup>(4)</sup>	320	-	-	-	-	320	190
Mr Peter T C Lee <sup>(4)</sup>	320	-	-	-	-	320	190
Dr Eric K C Li <sup>(4)</sup>	400	-	-	-	-	400	270
Dr Vincent H S Lo	280	-	-	-	-	280	150
Dr David W K Sin <sup>(4)</sup>	280	-	-	-	-	280	150
Mr Richard Y S Tang <sup>(4)</sup>	473	-	-	-	-	473	230
Mr Peter T S Wong	280 <sup>(3)</sup>	-	-	-	-	280	150
<b>Past Directors</b>	-	-	2,169	-	-	2,169	2,135
	<u>4,253</u>	<u>15,131</u>	<u>3,848</u>	<u>13,037</u>	<u>5,871</u>	<u>42,140</u>	<u>31,480</u>
2007	<u>2,794</u>	<u>13,672</u>	<u>3,809</u>	<u>9,406</u>	<u>1,799</u>		

Notes :

- (1) Fee receivable as a Director of Hang Seng Bank Limited was waived by the Director in 2008 while fees related to 2007 was surrendered to The Hongkong and Shanghai Banking Corporation in accordance with the HSBC Group's internal policy.
- (2) Fee receivable as a Director of Hang Seng Bank Limited were waived by the Directors in 2008.
- (3) 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.
- (4) Independent Non-Executive Director.
- (5) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK\$2.169 million in 2008. The Bank made contributions during 2008 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.
- (6) 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	
	2008	2007	2008	2007
Statutory audit services	13	12	8	8
Non-statutory audit services and others	7	6	5	3
	<u>20</u>	<u>18</u>	<u>13</u>	<u>11</u>

### 21 Gains less losses from financial investments and fixed assets

	2008	2007
Net gains from disposal of available-for-sale equity securities:		
- realisation of amounts previously recognised in reserves at 1 January	2,199	246
- net (losses)/gains arising in the year	(1,553)	203
	646	449
Net losses from disposal of available-for-sale debt securities	(83)	-
Impairment of available-for-sale equity securities	(284)	-
Gains less losses on disposal of investment properties	-	208
Gains less losses on disposal of fixed assets	(12)	59
	<u>267</u>	<u>716</u>

There was no profit or loss on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost during the year.

### 22 Net surplus on property revaluation

	2008	2007
Surplus of revaluation on investment properties (note 39(a))	8	250
Surplus of revaluation on assets held for sale	-	95
Reversal of revaluation deficit on premises (note 40(a))	71	34
	<u>79</u>	<u>379</u>

### 23 Tax expense

#### (a) Taxation in the consolidated income statement represents:

	2008	2007
<b>Current tax-provision for Hong Kong profits tax</b>		
Tax for the year	2,167	2,912
Adjustment in respect of prior year	(350)	(141)
	<u>1,817</u>	<u>2,771</u>
<b>Current tax-taxation outside Hong Kong</b>		
Tax for the year	(21)	29
<b>Deferred tax (note 50(b))</b>		
Origination and reversal of temporary differences	31	65
Effect of decrease in tax rate on deferred tax balances at 1 January	(48)	-
	<u>(17)</u>	<u>65</u>
<b>Total tax expense</b>	<u>1,779</u>	<u>2,865</u>

The current tax provision is based on the estimated assessable profit for 2008, 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 (2007: 17.5 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:

	2008	2007
Profit before tax	<u>15,878</u>	<u>21,471</u>
Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2007: 17.5%)	2,620	3,757
Tax effect of:		
- different tax rates in other countries/areas	(122)	(295)
- non-taxable income and non-deductible expenses	(68)	(260)
- share of results of associates	(298)	(196)
- reduction in tax rate on deferred tax opening balance	(48)	-
- others	(305)	(141)
Actual charge for taxation	<u>1,779</u>	<u>2,865</u>

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### 24 Profit attributable to shareholders

Of the profit attributable to shareholders, HK\$10,830 million (2007: HK\$15,122 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:

	2008	2007
Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements	10,598	15,113
Dividends declared during the year by subsidiaries from retained profits	<u>232</u>	<u>9</u>
The Bank's profit for the year (note 53)	<u>10,830</u>	<u>15,122</u>

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### 25 Earnings per share

The calculation of earnings per share for 2008 is based on earnings of HK\$14,099 million (HK\$18,242 million in 2007) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2007).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 26 Dividends per share

#### (a) Dividends attributable to the year:

	2008		2007	
	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	3.00	5,736	3.00	5,736
	<u>6.30</u>	<u>12,045</u>	<u>6.30</u>	<u>12,045</u>

The fourth interim dividend proposed after the balance sheet date has not been recognised as a liability at the balance sheet date.

#### (b) Dividends attributable to the previous year, approved and paid during the year:

	2008	2007
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK\$3.00 per share (2007: HK\$1.90 per share)	<u>5,736</u>	<u>3,633</u>

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### 27 Segmental analysis

Segmental information is presented in respect of business and geographical segments. Business by customer group information, which is more relevant to the Group in making operating and financial decisions, is chosen as the primary reporting format.

For the purpose of segmental analysis, the allocation of revenue reflects the benefits of capital and other funding resources allocated to the customer groups or geographical segments by way of internal capital allocation and funds 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 as inter-segment income for the "Other" customer group and inter-segment expenses for the respective customer groups.

#### (a) By customer group

The Group's business comprises five customer groups. 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.

NOTES TO THE FINANCIAL STATEMENTS (continued)

27 Segmental analysis (continued)

(a) By customer group (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Inter- segment elimination	Total
<b>2008</b>							
Net interest income	8,700	2,411	988	2,682	1,451	-	16,232
Net fee income/(expense)	3,696	1,066	127	(33)	113	-	4,969
Trading income/(loss)	743	245	18	641	(192)	-	1,455
Net (loss)/income from financial instruments designated at fair value	(1,043)	(2)	-	(10)	24	-	(1,031)
Dividend income	25	10	-	-	47	-	82
Net earned insurance premiums	12,135	213	3	-	-	-	12,351
Other operating income	439	54	2	4	202	-	701
Inter-segment income	-	-	-	-	469	(469)	-
<b>Total operating income</b>	<b>24,695</b>	<b>3,997</b>	<b>1,138</b>	<b>3,284</b>	<b>2,114</b>	<b>(469)</b>	<b>34,759</b>
Net insurance claims incurred and movement in policyholders' liabilities	(11,349)	(113)	(1)	-	-	-	(11,463)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>13,346</b>	<b>3,884</b>	<b>1,137</b>	<b>3,284</b>	<b>2,114</b>	<b>(469)</b>	<b>23,296</b>
Loan impairment charges and other credit risk provisions	(347)	(853)	(201)	(1,375)	-	-	(2,776)
<b>Net operating income</b>	<b>12,999</b>	<b>3,031</b>	<b>936</b>	<b>1,909</b>	<b>2,114</b>	<b>(469)</b>	<b>20,520</b>
Total operating expenses*	(4,490)	(1,470)	(314)	(235)	(286)	-	(6,795)
Inter-segment expenses	(389)	(60)	(8)	(12)	-	469	-
<b>Operating profit</b>	<b>8,120</b>	<b>1,501</b>	<b>614</b>	<b>1,662</b>	<b>1,828</b>	<b>-</b>	<b>13,725</b>
Gains less losses from financial investments and fixed assets	156	85	31	(84)	79	-	267
Net surplus on property revaluation	-	-	-	-	79	-	79
Share of profits from associates	134	884	-	701	88	-	1,807
Profit before tax	8,410	2,470	645	2,279	2,074	-	15,878
Share of profit before tax	52.9%	15.6%	4.1%	14.4%	13.0%	-	100.0%
Operating profit excluding inter-segment transactions	8,509	1,561	622	1,674	1,359	-	13,725
Operating profit excluding loan impairment charges and other credit risk provisions	8,467	2,354	815	3,037	1,828	-	16,501
* Depreciation/amortisation included in operating expenses	(140)	(24)	(7)	(3)	(318)	-	(492)
Total assets	211,092	85,791	93,570	345,920	25,795	-	762,168
Total liabilities	508,596	96,905	41,981	34,575	28,485	-	710,542
Investments in associates	501	3,194	-	2,784	2,391	-	8,870
Capital expenditure incurred during the year	374	52	14	3	223	-	666

NOTES TO THE FINANCIAL STATEMENTS (continued)

27 Segmental analysis (continued)

(a) By customer group (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Inter- segment elimination	Total
2007							
Net interest income	8,701	2,364	719	1,312	1,623	-	14,719
Net fee income/(expense)	5,726	1,005	109	(25)	71	-	6,886
Trading income/(loss)	1,086	173	9	468	(57)	-	1,679
Net income from financial instruments designated at fair value	1,901	2	-	4	-	-	1,907
Dividend income	14	1	-	-	37	-	52
Net earned insurance premiums	9,519	181	2	-	-	-	9,702
Other operating income/(expense)	543	47	-	(3)	160	-	747
Inter-segment income	-	-	-	-	373	(373)	-
<b>Total operating income</b>	<u>27,490</u>	<u>3,773</u>	<u>839</u>	<u>1,756</u>	<u>2,207</u>	<u>(373)</u>	<u>35,692</u>
Net insurance claims incurred and movement in policyholders' liabilities	(10,584)	(92)	(1)	-	-	-	(10,677)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<u>16,906</u>	<u>3,681</u>	<u>838</u>	<u>1,756</u>	<u>2,207</u>	<u>(373)</u>	<u>25,015</u>
Loan impairment charges and other credit risk provisions	(277)	(165)	(134)	-	-	-	(576)
<b>Net operating income</b>	<u>16,629</u>	<u>3,516</u>	<u>704</u>	<u>1,756</u>	<u>2,207</u>	<u>(373)</u>	<u>24,439</u>
Total operating expenses*	(4,442)	(1,437)	(234)	(214)	(323)	-	(6,650)
Inter-segment expenses	(325)	(34)	(6)	(8)	-	373	-
<b>Operating profit</b>	<u>11,862</u>	<u>2,045</u>	<u>464</u>	<u>1,534</u>	<u>1,884</u>	<u>-</u>	<u>17,789</u>
Gain on dilution of investment in associate	-	-	-	-	1,465	-	1,465
Gains less losses from financial investments and fixed assets	4	1	11	-	700	-	716
Net surplus on property revaluation	-	-	-	-	379	-	379
Share of profits from associates	52	655	-	295	120	-	1,122
Profit before tax	<u>11,918</u>	<u>2,701</u>	<u>475</u>	<u>1,829</u>	<u>4,548</u>	<u>-</u>	<u>21,471</u>
Share of profit before tax	<u>55.5%</u>	<u>12.6%</u>	<u>2.2%</u>	<u>8.5%</u>	<u>21.2%</u>	<u>-</u>	<u>100.0%</u>
Operating profit excluding inter-segment transactions	12,187	2,079	470	1,542	1,511	-	17,789
Operating profit excluding loan impairment charges and other credit risk provisions	12,139	2,210	598	1,534	1,884	-	18,365
* Depreciation/amortisation included in operating expenses	(118)	(21)	(5)	(3)	(234)	-	(381)
Total assets	<u>190,696</u>	<u>80,479</u>	<u>79,419</u>	<u>358,306</u>	<u>37,099</u>	<u>-</u>	<u>745,999</u>
Total liabilities	<u>459,756</u>	<u>100,857</u>	<u>53,373</u>	<u>42,486</u>	<u>33,071</u>	<u>-</u>	<u>689,543</u>
Investments in associates	<u>201</u>	<u>2,520</u>	<u>-</u>	<u>1,138</u>	<u>2,318</u>	<u>-</u>	<u>6,177</u>
Capital expenditure incurred during the year	<u>226</u>	<u>76</u>	<u>21</u>	<u>3</u>	<u>215</u>	<u>-</u>	<u>541</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 27 Segmental analysis (continued)

#### (b) By geographical region

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.

	2008	%	2007	%
<b>Total operating income</b>				
- Hong Kong	31,381	90	33,259	93
- Americas	2,378	7	1,782	5
- Mainland and other	1,000	3	651	2
	<u>34,759</u>	<u>100</u>	<u>35,692</u>	<u>100</u>
<b>Profit before tax</b>				
- Hong Kong	12,834	81	17,150	80
- Americas	1,771	11	1,748	8
- Mainland and other	1,273	8	2,573	12
	<u>15,878</u>	<u>100</u>	<u>21,471</u>	<u>100</u>
<b>Capital expenditure incurred during the year</b>				
- Hong Kong	545	82	432	80
- Americas	-	-	-	-
- Mainland and other	121	18	109	20
	<u>666</u>	<u>100</u>	<u>541</u>	<u>100</u>
<b>Total assets</b>				
- Hong Kong	656,411	86	630,989	85
- Americas	55,365	7	71,082	9
- Mainland and other	50,392	7	43,928	6
	<u>762,168</u>	<u>100</u>	<u>745,999</u>	<u>100</u>
<b>Total liabilities</b>				
- Hong Kong	680,296	96	663,333	96
- Americas	1,238	-	4,020	1
- Mainland and other	29,008	4	22,190	3
	<u>710,542</u>	<u>100</u>	<u>689,543</u>	<u>100</u>
<b>Contingent liabilities and commitments</b>				
- Hong Kong	196,778	94	200,462	93
- Americas	-	-	-	-
- Mainland and other	13,464	6	15,007	7
	<u>210,242</u>	<u>100</u>	<u>215,469</u>	<u>100</u>

**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 balance sheet date 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							Trading	No contractual maturity	Total
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years				
<b>2008</b>										
<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 debt securities in issue	-	-	-	-	-	-	-	-	-	-
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							Trading	No contractual maturity	Total
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years				
of which:										
Certificates of deposit:										
- included in trading assets	-	-	-	-	-	-	-	-	-	
- included in financial assets designated at fair value	-	-	8	15	140	-	-	-	163	
- included in available-for-sale investments	-	400	1,661	3,964	3,804	664	-	35	10,528	
- included in 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	
- included in financial assets designated at fair value	-	35	83	1,037	5,864	230	-	24	7,273	
- included in available-for-sale investments	5	9,521	13,846	23,165	85,553	1,788	-	114	133,992	
- included in 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	
- included in financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-	
- included in 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)

	Group								Total
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	
2007									
<b>Assets</b>									
Cash and balances with banks and other financial institutions	16,864	-	-	-	-	-	-	-	16,864
Placings with and advances to banks and other financial institutions	30,427	62,943	18,374	1,285	-	-	-	-	113,029
Trading assets	-	-	-	-	-	-	10,390	-	10,390
Financial assets designated at fair value	-	-	305	146	2,481	4,963	-	5,997	13,892
Derivative financial instruments	5	115	210	392	210	3	3,767	-	4,702
Advances to customers	19,863	15,111	24,885	50,290	93,575	104,632	-	-	308,356
Financial investments - available-for-sale investments	300	19,371	22,392	54,766	120,786	3,445	-	4,237	225,297
- held-to-maturity debt securities	-	-	66	305	5,609	13,017	-	-	18,997
Investments in associates	-	-	-	-	-	-	-	6,177	6,177
Investment properties	-	-	-	-	-	-	-	2,581	2,581
Premises, plant and equipment	-	-	-	-	-	-	-	6,794	6,794
Interest in leasehold land held for own use under operating lease	-	-	-	-	-	-	-	565	565
Intangible assets	-	-	-	-	-	-	-	2,889	2,889
Other assets	6,476	4,200	2,630	1,492	262	8	-	397	15,465
Deferred tax assets	-	-	-	-	-	-	-	1	1
	<u>73,935</u>	<u>101,740</u>	<u>68,862</u>	<u>108,676</u>	<u>222,923</u>	<u>126,068</u>	<u>14,157</u>	<u>29,638</u>	<u>745,999</u>
<b>Liabilities</b>									
Current, savings and other deposit accounts	312,427	177,361	42,612	13,055	913	285	-	-	546,653
Deposits from banks	1,791	12,994	2,640	2,311	-	-	-	-	19,736
Trading liabilities	-	-	-	-	-	-	48,151	-	48,151
Financial liabilities designated at fair value	41	-	-	-	997	-	-	460	1,498
Derivative financial instruments	-	7	11	25	47	58	4,535	-	4,683
Certificates of deposit and other debt securities in issue - certificates of deposit in issue	-	8	-	2,857	2,820	-	-	-	5,685
Other liabilities	8,433	4,996	1,718	1,352	124	12	-	1,215	17,850
Liabilities to customers under insurance contracts	-	-	-	-	-	-	-	33,089	33,089
Current tax liabilities	-	-	-	1,479	-	-	-	-	1,479
Deferred tax liabilities	-	-	-	-	-	-	-	1,365	1,365
Subordinated liabilities	-	-	-	-	9,354	-	-	-	9,354
	<u>322,692</u>	<u>195,366</u>	<u>46,981</u>	<u>21,079</u>	<u>14,255</u>	<u>355</u>	<u>52,686</u>	<u>36,129</u>	<u>689,543</u>



NOTES TO THE FINANCIAL STATEMENTS (continued)

28 Analysis of assets and liabilities by remaining maturity (continued)

	Group							Trading	No contractual maturity	Total
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years				
of which:										
Certificates of deposit:										
- included in trading assets	-	-	-	-	-	-	-	-	-	
- included in financial assets designated at fair value	-	-	5	8	39	-	-	-	52	
- included in available-for-sale investments	-	3,295	2,965	11,276	10,815	661	-	-	29,012	
- included in held-to-maturity debt securities	-	-	9	120	989	117	-	-	1,235	
	<u>-</u>	<u>3,295</u>	<u>2,979</u>	<u>11,404</u>	<u>11,843</u>	<u>778</u>	<u>-</u>	<u>-</u>	<u>30,299</u>	
Debt securities:										
- included in trading assets	-	-	-	-	-	-	10,361	-	10,361	
- included in financial assets designated at fair value	-	-	300	138	2,442	4,963	-	17	7,860	
- included in available-for-sale investments	300	16,076	19,427	43,490	109,971	2,784	-	(62)	191,986	
- included in held-to-maturity debt securities	-	-	57	185	4,620	12,900	-	-	17,762	
	<u>300</u>	<u>16,076</u>	<u>19,784</u>	<u>43,813</u>	<u>117,033</u>	<u>20,647</u>	<u>10,361</u>	<u>(45)</u>	<u>227,969</u>	
Certificates of deposit in issue:										
- included in trading liabilities	-	-	-	-	-	-	3,527	-	3,527	
- included in financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-	
- included in issue at amortised cost	-	8	-	2,857	2,820	-	-	-	5,685	
	<u>-</u>	<u>8</u>	<u>-</u>	<u>2,857</u>	<u>2,820</u>	<u>-</u>	<u>3,527</u>	<u>-</u>	<u>9,212</u>	

NOTES TO THE FINANCIAL STATEMENTS (continued)

28 Analysis of assets and liabilities by remaining maturity (continued)

	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	Bank		Trading	No contractual maturity	Total
					One year to five years	Over five years			
<b>2008</b>									
<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	One month to three months	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
of which:									
Certificates of deposit:									
- included in trading assets	-	-	-	-	-	-	-	-	-
- included in financial assets designated at fair value	-	-	-	-	-	-	-	-	-
- included in available-for-sale investments	-	400	1,661	3,413	1,790	664	-	35	7,963
- included in 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
- included in financial assets designated at fair value	-	-	-	639	166	-	-	25	830
- included in available-for-sale investments	5	5,166	9,267	18,699	68,724	1,788	-	114	103,763
- included in 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
- included in financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-
- included in 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)

	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	Bank One year to five years	Over five years	Trading	No contractual maturity	Total
2007									
<b>Assets</b>									
Cash and balances with banks and other financial institutions	13,362	-	-	-	-	-	-	-	13,362
Placings with and advances to banks and other financial institutions	24,567	45,418	16,096	56	-	-	-	-	86,137
Trading assets	-	-	-	-	-	-	8,904	-	8,904
Financial assets designated at fair value	-	-	272	100	850	-	-	16	1,238
Derivative financial instruments	5	98	188	340	149	3	3,628	-	4,411
Advances to customers	19,698	13,557	21,315	40,305	74,179	86,359	-	-	255,413
Amounts due from subsidiaries	66,520	3,981	27,523	3,583	1,199	-	-	-	102,806
Financial investments - available-for-sale investments	300	15,042	18,468	45,480	89,573	3,294	-	442	172,599
Investments in subsidiaries	-	-	-	-	-	-	-	11,284	11,284
Investments in associates	-	-	-	-	-	-	-	1,634	1,634
Investment properties	-	-	-	-	-	-	-	1,708	1,708
Premises, plant and equipment	-	-	-	-	-	-	-	4,127	4,127
Interest in leasehold land held for own use under operating lease	-	-	-	-	-	-	-	565	565
Intangible assets	-	-	-	-	-	-	-	234	234
Other assets	6,277	3,556	2,005	1,236	-	-	-	188	13,262
Deferred tax assets	-	-	-	-	-	-	-	-	-
	<u>130,729</u>	<u>81,652</u>	<u>85,867</u>	<u>91,100</u>	<u>165,950</u>	<u>89,656</u>	<u>12,532</u>	<u>20,198</u>	<u>677,684</u>
<b>Liabilities</b>									
Current, savings and other deposit accounts	307,776	171,785	41,231	11,673	580	285	-	-	533,330
Deposits from banks	1,654	9,625	1,015	299	-	-	-	-	12,593
Trading liabilities	-	-	-	-	-	-	47,150	-	47,150
Financial liabilities designated at fair value	-	-	-	-	997	-	-	(8)	989
Derivative financial instruments	-	7	9	21	46	58	4,290	-	4,431
Certificates of deposit and other debt securities in issue - certificates of deposit in issue	-	11	1,516	2,856	2,820	-	-	-	7,203
Amounts due to subsidiaries	3,124	2,241	-	-	-	-	-	-	5,365
Other liabilities	8,346	4,779	1,468	1,203	60	12	-	1,953	17,821
Current tax liabilities	-	-	-	1,332	-	-	-	-	1,332
Deferred tax liabilities	-	-	-	-	-	-	-	649	649
Subordinated liabilities	-	-	-	-	9,354	-	-	-	9,354
	<u>320,900</u>	<u>188,448</u>	<u>45,239</u>	<u>17,384</u>	<u>13,857</u>	<u>355</u>	<u>51,440</u>	<u>2,594</u>	<u>640,217</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

28 Analysis of assets and liabilities by remaining maturity (continued)

	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	Bank One year to five years	Over five years	Trading	No contractual maturity	Total
of which:									
Certificates of deposit:									
- included in trading assets	-	-	-	-	-	-	-	-	-
- included in financial assets designated at fair value	-	-	-	-	-	-	-	-	-
- included in available-for-sale investments	-	1,028	2,449	8,703	7,301	661	-	-	20,142
- included in held-to-maturity debt securities	-	-	-	-	-	-	-	-	-
	<u>-</u>	<u>1,028</u>	<u>2,449</u>	<u>8,703</u>	<u>7,301</u>	<u>661</u>	<u>-</u>	<u>-</u>	<u>20,142</u>
Debt securities:									
- included in trading assets	-	-	-	-	-	-	8,875	-	8,875
- included in financial assets designated at fair value	-	-	272	100	850	-	-	16	1,238
- included in available-for-sale investments	300	14,014	16,019	36,777	82,272	2,633	-	(50)	151,965
- included in held-to-maturity debt securities	-	-	-	-	-	-	-	-	-
	<u>300</u>	<u>14,014</u>	<u>16,291</u>	<u>36,877</u>	<u>83,122</u>	<u>2,633</u>	<u>8,875</u>	<u>(34)</u>	<u>162,078</u>
Certificates of deposit in issue:									
- included in trading liabilities	-	-	-	-	-	-	3,527	-	3,527
- included in financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-
- included in issue at amortised cost	-	11	1,516	2,856	2,820	-	-	-	7,203
	<u>-</u>	<u>11</u>	<u>1,516</u>	<u>2,856</u>	<u>2,820</u>	<u>-</u>	<u>3,527</u>	<u>-</u>	<u>10,730</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						Total
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	
<b>2008</b>							
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							23,073
<b>Total assets</b>							<u>762,168</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	-	-	-	-	4,583	13,364
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>593,493</u>	<u>658,127</u>
Non-financial liabilities							52,415
<b>Total liabilities</b>							<u>710,542</u>

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

**29 Accounting classifications** (continued)

	Group						
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	Total
2007							
Cash and balances with banks and other financial institutions	-	-	-	-	-	16,864	16,864
Placings with and advances to banks and other financial institutions	-	-	-	-	113,029	-	113,029
Derivative financial instruments	3,750	17	935	-	-	-	4,702
Advances to customers	-	-	-	-	308,356	-	308,356
Investment securities	10,363	13,892	225,297	18,997	-	-	268,549
Acceptances and endorsements	-	-	-	-	-	3,294	3,294
Other financial assets	27	-	-	-	-	11,789	11,816
Total financial assets	<u>14,140</u>	<u>13,909</u>	<u>226,232</u>	<u>18,997</u>	<u>421,385</u>	<u>31,947</u>	<u>726,610</u>
Non-financial assets							19,389
<b>Total assets</b>							<u><u>745,999</u></u>
Current, savings and other deposit accounts	24,162	-	-	-	-	546,653	570,815
Deposits from banks	-	-	-	-	-	19,736	19,736
Derivative financial instruments	4,462	73	148	-	-	-	4,683
Certificates of deposit and other debt securities in issue	14,087	-	-	-	-	5,685	19,772
Other financial liabilities	9,902	-	-	-	-	8,407	18,309
Subordinated liabilities	-	989	-	-	-	9,354	10,343
Liabilities to customers under investment contracts	-	509	-	-	-	-	509
Acceptances and endorsements	-	-	-	-	-	3,294	3,294
Total financial liabilities	<u>52,613</u>	<u>1,571</u>	<u>148</u>	<u>-</u>	<u>-</u>	<u>593,129</u>	<u>647,461</u>
Non-financial liabilities							42,082
<b>Total liabilities</b>							<u><u>689,543</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	
<b>2008</b>							
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							<u>21,160</u>
<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	-	-	-	-	4,575	13,356
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>583,134</u>	<u>642,533</u>
Non-financial liabilities							<u>8,046</u>
<b>Total liabilities</b>							<u><u>650,579</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
2007							
Cash and balances with banks and other financial institutions	-	-	-	-	-	13,362	13,362
Placings with and advances to banks and other financial institutions	-	-	-	-	86,137	-	86,137
Derivative financial instruments	3,622	6	783	-	-	-	4,411
Advances to customers	-	-	-	-	255,413	-	255,413
Investment securities	8,877	1,238	172,599	-	-	-	182,714
Amounts due from subsidiaries	-	-	-	-	-	102,806	102,806
Acceptances and endorsements	-	-	-	-	-	2,930	2,930
Other financial assets	27	-	-	-	-	10,010	10,037
Total financial assets	<u>12,526</u>	<u>1,244</u>	<u>173,382</u>	<u>-</u>	<u>341,550</u>	<u>129,108</u>	<u>657,810</u>
Non-financial assets							19,874
<b>Total assets</b>							<u><u>677,684</u></u>
Current, savings and other deposit accounts	23,161	-	-	-	-	533,330	556,491
Deposits from banks	-	-	-	-	-	12,593	12,593
Derivative financial instruments	4,276	14	141	-	-	-	4,431
Certificates of deposit and other debt securities in issue	14,087	-	-	-	-	7,203	21,290
Amounts due to subsidiaries	-	-	-	-	-	5,365	5,365
Other financial liabilities	9,902	-	-	-	-	8,407	18,309
Subordinated liabilities	-	989	-	-	-	9,354	10,343
Acceptances and endorsements	-	-	-	-	-	2,930	2,930
Total financial liabilities	<u>51,426</u>	<u>1,003</u>	<u>141</u>	<u>-</u>	<u>-</u>	<u>579,182</u>	<u>631,752</u>
Non-financial liabilities							8,465
<b>Total liabilities</b>							<u><u>640,217</u></u>

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

### 30 Cash and balances with banks and other financial institutions

	Group		Bank	
	2008	2007	2008	2007
Cash in hand	3,696	3,308	3,488	3,118
Balances with central banks	2,426	6,004	896	4,119
Balances with banks and other financial institutions	18,700	7,552	17,687	6,125
	<u>24,822</u>	<u>16,864</u>	<u>22,071</u>	<u>13,362</u>

### 31 Placings with and advances to banks and other financial institutions

	Group		Bank	
	2008	2007	2008	2007
Placings with and advances to banks and other financial institutions maturing within one month	47,025	93,370	23,776	69,984
Placings with and advances to banks and other financial institutions maturing after one month but less than one year	22,554	19,659	14,321	16,153
Placings with and advances to banks and other financial institutions maturing after one year	-	-	-	-
	<u>69,579</u>	<u>113,029</u>	<u>38,097</u>	<u>86,137</u>

There were no overdue advances, impaired advances and rescheduled advances to banks and other financial institutions at 31 December 2008 by the Group and the Bank. (2007: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

32 Trading assets

	Group		Bank	
	2008	2007	2008	2007
Treasury bills	103,621	6,303	103,463	5,645
Certificates of deposit	-	-	-	-
Other debt securities	4,750	4,058	4,294	3,230
Debt securities	108,371	10,361	107,757	8,875
Equity shares	-	2	-	2
<b>Total trading securities</b>	<b>108,371</b>	<b>10,363</b>	<b>107,757</b>	<b>8,877</b>
Other*	18	27	18	27
<b>Total trading assets</b>	<b>108,389</b>	<b>10,390</b>	<b>107,775</b>	<b>8,904</b>
<b>Debt securities:</b>				
- listed in Hong Kong	3,631	2,564	3,631	2,564
- listed outside Hong Kong	269	796	269	315
	3,900	3,360	3,900	2,879
- unlisted	104,471	7,001	103,857	5,996
	108,371	10,361	107,757	8,875
<b>Equity shares:</b>				
- listed in Hong Kong	-	2	-	2
- unlisted	-	-	-	-
	-	2	-	2
<b>Total trading securities</b>	<b>108,371</b>	<b>10,363</b>	<b>107,757</b>	<b>8,877</b>
<b>Debt securities</b>				
Issued by public bodies:				
- central governments and central banks	107,428	9,061	106,814	7,922
- other public sector entities	378	387	378	387
	107,806	9,448	107,192	8,309
Issued by other bodies:				
- banks and other financial institutions	306	562	306	215
- corporate entities	259	351	259	351
	565	913	565	566
	108,371	10,361	107,757	8,875
<b>Equity shares</b>				
Issued by corporate entities	-	2	-	2
<b>Total trading securities</b>	<b>108,371</b>	<b>10,363</b>	<b>107,757</b>	<b>8,877</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	
	2008	2007	2008	2007
Certificates of deposit	163	52	-	-
Other debt securities	7,273	7,860	830	1,238
Debt securities	7,436	7,912	830	1,238
Equity shares	362	5,980	-	-
	<u>7,798</u>	<u>13,892</u>	<u>830</u>	<u>1,238</u>
<b>Debt securities:</b>				
- listed in Hong Kong	834	1,113	449	700
- listed outside Hong Kong	1,004	1,377	276	291
	1,838	2,490	725	991
- unlisted	5,598	5,422	105	247
	<u>7,436</u>	<u>7,912</u>	<u>830</u>	<u>1,238</u>
<b>Equity shares:</b>				
- listed in Hong Kong	26	1,976	-	-
- listed outside Hong Kong	57	1,600	-	-
	83	3,576	-	-
- unlisted	279	2,404	-	-
	<u>362</u>	<u>5,980</u>	<u>-</u>	<u>-</u>
	<u>7,798</u>	<u>13,892</u>	<u>830</u>	<u>1,238</u>
<b>Debt securities</b>				
Issued by public bodies:				
- central governments and central banks	924	2,004	517	763
- other public sector entities	564	395	226	250
	1,488	2,399	743	1,013
Issued by other bodies:				
- banks and other financial institutions	5,317	4,682	65	182
- corporate entities	631	831	22	43
	5,948	5,513	87	225
	<u>7,436</u>	<u>7,912</u>	<u>830</u>	<u>1,238</u>
<b>Equity shares</b>				
Issued by corporate entities	362	5,980	-	-
	<u>7,798</u>	<u>13,892</u>	<u>830</u>	<u>1,238</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 designated as either fair value hedge or cash flow hedges.

#### 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 hedges

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 hedges of forecast transactions.

There was no ineffectiveness recognised in the Group's income statement arising from cash flow hedges during the years 2008 and 2007.

The schedules of forecast principal balances on which the expected interest cash flows associated with derivatives that are cash flow hedges were as follows:

	Group		
	Three months or less	Three months to one year	One year to five years
<b>At 31 December 2008</b>			
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>
<b>At 31 December 2007</b>			
Cash inflows from assets	50,981	37,578	12,922
Cash outflows from liabilities	-	-	-
Net cash inflows	<u>50,981</u>	<u>37,578</u>	<u>12,922</u>

During the years 2008 and 2007, there was no forecast transaction for which hedge accounting had previously been used but which were no longer expected to occur.

## 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					
	2008			2007		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
<b>Derivatives held for trading</b>						
Foreign exchange contracts:						
- spot and forward foreign exchange	570,950	2,676	5,144	636,076	2,074	1,716
- currency swaps	18,356	337	229	3,136	44	41
- currency options purchased	32,729	287	-	22,930	143	-
- currency options written	33,601	-	340	62,329	-	315
- other exchange rate contracts	141	-	4	30	-	-
	<u>655,777</u>	<u>3,300</u>	<u>5,717</u>	<u>724,501</u>	<u>2,261</u>	<u>2,072</u>
Interest rate contracts:						
- interest rate swaps	161,018	2,120	2,249	127,263	697	763
- interest rate options purchased	142	-	-	312	-	-
- interest rate options written	142	-	-	79	-	-
- other interest rate contracts	217	1	-	-	-	-
	<u>161,519</u>	<u>2,121</u>	<u>2,249</u>	<u>127,654</u>	<u>697</u>	<u>763</u>
Equity and other contracts:						
- equity swaps	13,025	1	6,271	12,371	14	1,139
- equity options purchased	2,680	113	-	14,338	527	-
- equity options written	2,770	-	100	14,374	-	487
- other equity contracts	8	-	-	2	-	-
- spot and forward contract	2,685	128	9	1,361	251	1
	<u>21,168</u>	<u>242</u>	<u>6,380</u>	<u>42,446</u>	<u>792</u>	<u>1,627</u>
<b>Total derivatives held for trading</b>	<u><b>838,464</b></u>	<u><b>5,663</b></u>	<u><b>14,346</b></u>	<u><b>894,601</b></u>	<u><b>3,750</b></u>	<u><b>4,462</b></u>
<b>Derivatives designated at fair value</b>						
Interest rate contracts:						
- interest rate swaps	1,797	31	30	2,207	6	14
Equity contracts:						
- other equity contracts	-	-	-	2,898	11	59
	<u>1,797</u>	<u>31</u>	<u>30</u>	<u>5,105</u>	<u>17</u>	<u>73</u>
<b>Cash Flow hedges derivatives</b>						
Interest rate contracts:						
- interest rate swaps	73,394	1,410	14	51,258	888	28
<b>Fair value hedge derivatives</b>						
Interest rate contracts:						
- interest rate swaps	12,548	-	555	8,974	47	120
<b>Total derivatives</b>	<u><b>926,203</b></u>	<u><b>7,104</b></u>	<u><b>14,945</b></u>	<u><b>959,938</b></u>	<u><b>4,702</b></u>	<u><b>4,683</b></u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 34 Derivative financial instruments (continued)

	Bank					
	2008			2007		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
<b>Derivatives held for trading</b>						
Foreign exchange contracts:						
- spot and forward foreign exchange	567,613	2,621	5,145	627,410	1,948	1,534
- currency swaps	18,356	337	229	3,136	44	41
- currency options purchased	32,735	287	-	22,977	143	-
- currency options written	33,601	-	356	62,330	-	314
- other exchange rate contracts	141	-	4	30	-	-
	<u>652,446</u>	<u>3,245</u>	<u>5,734</u>	<u>715,883</u>	<u>2,135</u>	<u>1,889</u>
Interest rate contracts:						
- interest rate swaps	160,254	2,119	2,232	126,839	696	760
- interest rate options purchased	142	-	-	312	-	-
- interest rate options written	142	-	-	79	-	-
- other interest rate contracts	217	1	-	-	-	-
	<u>160,755</u>	<u>2,120</u>	<u>2,232</u>	<u>127,230</u>	<u>696</u>	<u>760</u>
Equity and other contracts:						
- equity swaps	14,097	62	6,271	12,847	14	1,139
- equity options purchased	2,680	114	-	14,338	526	-
- equity options written	2,770	-	100	14,376	-	487
- other equity contracts	8	-	-	2	-	-
- spot and forward contract	2,685	128	9	1,361	251	1
	<u>22,240</u>	<u>304</u>	<u>6,380</u>	<u>42,924</u>	<u>791</u>	<u>1,627</u>
Total derivatives held for trading	<u>835,441</u>	<u>5,669</u>	<u>14,346</u>	<u>886,037</u>	<u>3,622</u>	<u>4,276</u>
<b>Derivatives designated at fair value</b>						
Interest rate contracts:						
- interest rate swaps	<u>1,797</u>	<u>31</u>	<u>30</u>	<u>2,207</u>	<u>6</u>	<u>14</u>
<b>Cash Flow hedges derivatives</b>						
Interest rate contracts:						
- interest rate swaps	<u>68,165</u>	<u>1,210</u>	<u>14</u>	<u>45,763</u>	<u>756</u>	<u>26</u>
<b>Fair value hedge derivatives</b>						
Interest rate contracts:						
- interest rate swaps	<u>12,428</u>	<u>-</u>	<u>548</u>	<u>7,104</u>	<u>27</u>	<u>115</u>
<b>Total derivatives</b>	<u>917,831</u>	<u>6,910</u>	<u>14,938</u>	<u>941,111</u>	<u>4,411</u>	<u>4,431</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 balance sheet date, 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 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 mark-to-market assets with any negative mark-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 effect from 1 January 2008, the Group uses the foundation internal ratings-based ("IRB") approach approved by the Hong Kong Monetary Authority for calculating the credit risks for the majority of its non-securitization exposures, with the remainder of its credits risks assessed using the standardised (credit risk) approach. In 2007, the Group used the standardised (credit risk) approach. The figures are therefore not strictly comparable.

	Group			Bank		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
<b>2008</b>						
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 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)

### 34 Derivative financial instruments (continued)

#### (d) Contract amounts, credit equivalent amounts and risk-weighted amounts (continued)

	Group			Bank		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
2007						
Exchange rate contracts:						
Spot and forward foreign exchange	580,889	7,606	2,196	576,133	7,467	2,114
Currency swaps	3,136	170	49	3,136	170	49
Currency options purchased	22,821	633	140	22,821	633	140
Other exchange rate contracts	-	-	-	-	-	-
	<u>606,846</u>	<u>8,409</u>	<u>2,385</u>	<u>602,090</u>	<u>8,270</u>	<u>2,303</u>
Interest rate contracts:						
Interest rate swaps	189,703	2,121	520	181,913	1,945	475
Interest rate options purchased	312	-	-	312	-	-
Other interest rate contracts	-	-	-	-	-	-
	<u>190,015</u>	<u>2,121</u>	<u>520</u>	<u>182,225</u>	<u>1,945</u>	<u>475</u>
Equity contracts:						
Equity swaps	12,362	905	183	12,838	944	202
Equity options purchased	14,347	1,389	1,080	14,347	1,389	1,080
Other equity contracts	-	-	-	-	-	-
	<u>26,709</u>	<u>2,294</u>	<u>1,263</u>	<u>27,185</u>	<u>2,333</u>	<u>1,282</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 35 Advances to customers

#### (a) Advances to customers

	Group		Bank	
	2008	2007	2008	2007
Gross advances to customers	331,164	309,409	281,996	256,370
Less: loan impairment allowances				
- individually assessed	(1,241)	(417)	(1,046)	(330)
- collectively assessed	(802)	(636)	(695)	(627)
	<u>329,121</u>	<u>308,356</u>	<u>280,255</u>	<u>255,413</u>
Included in advances to customers are:				
- trade bills	2,899	3,690	2,806	3,590
- loan impairment allowances	(30)	(14)	(30)	(13)
	<u>2,869</u>	<u>3,676</u>	<u>2,776</u>	<u>3,577</u>

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

	Group		Bank	
	2008 %	2007 %	2008 %	2007 %
Loan impairment allowances:				
- individually assessed	0.37	0.13	0.37	0.13
- collectively assessed	0.24	0.21	0.25	0.24
Total loan impairment allowances	<u>0.61</u>	<u>0.34</u>	<u>0.62</u>	<u>0.37</u>

#### (b) Loan impairment allowances against advances to customers

	Group		
	Individually assessed	Collectively assessed	Total
<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>
<b>2007</b>			
At 1 January	406	518	924
Amounts written off	(242)	(249)	(491)
Recoveries of advances written off in previous years	21	41	62
New impairment allowances charged			
to income statement (note 16)	335	367	702
Impairment allowances released to income statement (note 16)	(85)	(41)	(126)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(18)	-	(18)
At 31 December	<u>417</u>	<u>636</u>	<u>1,053</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>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>
<b>2007</b>			
At 1 January	332	504	836
Amounts written off	(219)	(249)	(468)
Recoveries of advances written off in previous years	9	40	49
New impairment allowances charged to income statement (note 16)	314	372	686
Impairment allowances released to income statement (note 16)	(59)	(40)	(99)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(8)	-	(8)
Transfer to subsidiaries	(39)	-	(39)
At 31 December	<u>330</u>	<u>627</u>	<u>957</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 35 Advances to customers (continued)

#### (c) Impaired advances and allowances

	Group		Bank	
	2008	2007	2008	2007
Gross impaired advances	3,404	1,261	2,032	766
Individually assessed allowances	<u>(1,241)</u>	<u>(417)</u>	<u>(1,046)</u>	<u>(330)</u>
Net impaired advances	<u>2,163</u>	<u>844</u>	<u>986</u>	<u>436</u>
Individually assessed allowances as a percentage of gross impaired advances	<u>36.5%</u>	<u>33.1%</u>	<u>51.5%</u>	<u>43.1%</u>
Gross impaired advances as a percentage of gross advances to customers	<u>1.0%</u>	<u>0.4%</u>	<u>0.7%</u>	<u>0.3%</u>

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

	Group		Bank	
	2008	2007	2008	2007
Gross individually assessed impaired advances	3,297	1,183	1,925	688
Individually assessed allowances	<u>(1,241)</u>	<u>(417)</u>	<u>(1,046)</u>	<u>(330)</u>
	<u>2,056</u>	<u>766</u>	<u>879</u>	<u>358</u>
Gross individually assessed impaired advances as a percentage of gross advances to customers	<u>1.0%</u>	<u>0.4%</u>	<u>0.7%</u>	<u>0.3%</u>
Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers	<u>1,502</u>	<u>754</u>	<u>1,102</u>	<u>495</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:

2008	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	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	

2007

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	329	0.1	165	0.1
- more than six months but not more than one year	312	0.1	61	-
- more than one year	112	-	102	-
	<u>753</u>	<u>0.2</u>	<u>328</u>	<u>0.1</u>

of which:

- individually impaired allowances	(278)		(215)	
- covered portion of overdue loans and advances	401		204	
- uncovered portion of overdue loans and advances	352		124	
- current market value held against the covered portion of overdue loans and advances	796		421	

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	
		%		%
2008	<u>281</u>	<u>0.1</u>	<u>169</u>	<u>0.1</u>
2007	<u>352</u>	<u>0.1</u>	<u>208</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 2008, about 90 per cent (over 90 per cent at 31 December 2007) 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 Hong Kong Monetary Authority ("HKMA") is as follows:

	Group			
	2008	% of gross advances covered by collateral	2007	% 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	25,314	32.7	20,431	32.8
- property investment	66,179	87.4	54,676	84.3
- financial concerns	3,146	60.7	3,232	20.0
- stockbrokers	526	39.2	524	81.9
- wholesale and retail trade	6,183	54.3	6,034	46.5
- manufacturing	12,828	27.0	8,311	29.7
- transport and transport equipment	8,400	78.3	9,368	69.9
- recreational activities	26	64.6	218	1.4
- information technology	1,075	4.6	913	2.3
- other	21,553	41.7	21,396	51.0
	<u>145,230</u>	62.4	<u>125,103</u>	61.3
<b>Individuals</b>				
- advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	16,739	99.9	18,437	99.8
- advances for the purchase of other residential properties	89,669	99.4	85,923	99.6
- credit card advances	12,841	-	11,354	-
- other	11,892	33.0	13,155	30.6
	<u>131,141</u>	83.7	<u>128,869</u>	83.8
<b>Total gross advances for use in Hong Kong</b>	<b>276,371</b>	<b>72.5</b>	<b>253,972</b>	<b>72.7</b>
<b>Trade finance</b>	<b>19,039</b>	<b>41.5</b>	<b>22,995</b>	<b>32.7</b>
<b>Gross advances for use outside Hong Kong</b>	<b>35,754</b>	<b>59.4</b>	<b>32,442</b>	<b>50.8</b>
<b>Gross advances to customers</b>	<b><u>331,164</u></b>	<b>69.3</b>	<b><u>309,409</u></b>	<b>67.4</b>



NOTES TO THE FINANCIAL STATEMENTS (continued)

35 Advances to customers (continued)

(g) Gross advances to customers by industry sector (continued)

	2008	% of gross advances covered by collateral	Bank	
			2007	% 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	25,004	31.9	20,153	31.9
- property investment	64,869	88.0	53,170	84.9
- financial concerns	3,146	60.7	3,232	20.0
- stockbrokers	526	39.2	524	81.9
- wholesale and retail trade	6,181	54.3	6,031	46.5
- manufacturing	12,826	27.0	8,298	29.6
- transport and transport equipment	5,620	67.5	6,168	55.8
- recreational activities	26	64.6	218	1.4
- information technology	1,075	4.6	913	2.3
- other	21,524	41.6	21,220	51.3
	<u>140,797</u>	<b>61.6</b>	<u>119,927</u>	<b>60.3</b>
<b>Individuals</b>				
- advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	3,318	99.5	2,457	99.3
- advances for the purchase of other residential properties	84,971	99.4	79,835	99.6
- credit card advances	12,841	-	11,354	-
- other	11,880	32.9	13,134	30.6
	<u>113,010</u>	<b>81.1</b>	<u>106,780</u>	<b>80.5</b>
<b>Total gross advances for use in Hong Kong</b>	<b>253,807</b>	<b>70.3</b>	<b>226,707</b>	<b>69.8</b>
<b>Trade finance</b>	<b>19,039</b>	<b>41.5</b>	<b>22,995</b>	<b>32.7</b>
<b>Gross advances for use outside Hong Kong</b>	<b>9,150</b>	<b>26.9</b>	<b>6,668</b>	<b>21.7</b>
<b>Gross advances to customers</b>	<b><u>281,996</u></b>	<b>67.0</b>	<b><u>256,370</u></b>	<b>65.2</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 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	
	2008	2007	2008	2007
Finance leases	51	69	51	59
Hire purchase contracts	7,329	7,422	4,515	4,024
	<u>7,380</u>	<u>7,491</u>	<u>4,566</u>	<u>4,083</u>

	Group		
	Present value of minimum lease payments receivable	Interest income relating to future periods	Total minimum lease payments receivable
<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>		
<b>2007</b>			
Amounts receivable:			
- within one year	701	293	994
- after one year but within five years	1,716	940	2,656
- after five years	5,098	1,967	7,065
	<u>7,515</u>	<u>3,200</u>	<u>10,715</u>
Loans impairment allowances	(24)		
Net investments in finance leases and hire purchase contracts	<u>7,491</u>		

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

### 35 Advances to customers *(continued)*

#### (h) Net investments in finance leases *(continued)*

	<b>Present</b>	<b>Bank</b>	
	<b>value of</b>	<b>Interest</b>	<b>Total</b>
	<b>minimum</b>	<b>income</b>	<b>minimum</b>
	<b>lease</b>	<b>relating</b>	<b>lease</b>
	<b>payments</b>	<b>to future</b>	<b>payments</b>
	<b>receivable</b>	<b>periods</b>	<b>receivable</b>
<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	2,875	580	3,455
	<u>4,585</u>	<u>956</u>	<u>5,541</u>
Loans impairment allowances	(19)		
Net investments in finance leases and hire purchase contracts	<u>4,566</u>		
<b>2007</b>			
Amounts receivable:			
- within one year	400	154	554
- after one year but within five years	968	485	1,453
- after five years	2,718	1,227	3,945
	<u>4,086</u>	<u>1,866</u>	<u>5,952</u>
Loans impairment allowances	(3)		
Net investments in finance leases and hire purchase contracts	<u>4,083</u>		

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 36 Financial investments

	Group		Bank	
	2008	2007	2008	2007
Financial investments:				
- which may be repledged or resold by counterparties	1,260	-	219	-
- which may not be repledged or resold or are not subject to repledge or resale by counterparties	<u>179,899</u>	<u>244,294</u>	<u>111,781</u>	<u>172,599</u>
	<u>181,159</u>	<u>244,294</u>	<u>112,000</u>	<u>172,599</u>
Held-to-maturity debt securities at amortised cost	36,205	18,997	-	-
Available-for-sale at fair value:				
- debt securities	144,520	220,998	111,726	172,107
- equity shares	434	4,299	274	492
	<u>181,159</u>	<u>244,294</u>	<u>112,000</u>	<u>172,599</u>
Treasury bills	9,927	3,089	4,304	3,089
Certificates of deposit	12,871	30,247	7,963	20,142
Other debt securities	<u>157,927</u>	<u>206,659</u>	<u>99,459</u>	<u>148,876</u>
Debt securities	180,725	239,995	111,726	172,107
Equity shares	434	4,299	274	492
	<u>181,159</u>	<u>244,294</u>	<u>112,000</u>	<u>172,599</u>

#### (a) Held-to-maturity debt securities

	Group		Bank	
	2008	2007	2008	2007
Listed in Hong Kong	1,227	35	-	-
Listed outside Hong Kong	<u>3,301</u>	<u>656</u>	-	-
	4,528	691	-	-
Unlisted	<u>31,677</u>	<u>18,306</u>	-	-
	<u>36,205</u>	<u>18,997</u>	-	-
Issued by public bodies:				
- central governments and central banks	240	246	-	-
- other public sector entities	<u>2,343</u>	<u>727</u>	-	-
	2,583	973	-	-
Issued by other bodies:				
- banks and other financial institutions	29,604	17,463	-	-
- corporate entities	<u>4,018</u>	<u>561</u>	-	-
	<u>33,622</u>	<u>18,024</u>	-	-
	<u>36,205</u>	<u>18,997</u>	-	-
Fair value of held-to-maturity debt securities:				
- listed	4,849	719	-	-
- unlisted	<u>34,466</u>	<u>18,807</u>	-	-
	<u>39,315</u>	<u>19,526</u>	-	-

There were no held-to-maturity debt securities determined to be impaired at 31 December 2008 for the Group and the Bank (2007: Nil).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 36 Financial investments (continued)

#### (b) Available-for-sale debt securities

	Group		Bank	
	2008	2007	2008	2007
Listed in Hong Kong	4,377	5,199	4,369	5,199
Listed outside Hong Kong	63,717	71,341	50,273	49,523
	<u>68,094</u>	<u>76,540</u>	<u>54,642</u>	<u>54,722</u>
Unlisted	76,426	144,458	57,084	117,385
	<u>144,520</u>	<u>220,998</u>	<u>111,726</u>	<u>172,107</u>
Issued by public bodies:				
- central governments and central banks	16,403	8,280	10,238	7,745
- other public sector entities	2,010	4,961	2,010	4,686
	<u>18,413</u>	<u>13,241</u>	<u>12,248</u>	<u>12,431</u>
Issued by other bodies:				
- banks and other financial institutions	114,563	194,105	91,096	149,860
- corporate entities	11,544	13,652	8,382	9,816
	<u>126,107</u>	<u>207,757</u>	<u>99,478</u>	<u>159,676</u>
	<u>144,520</u>	<u>220,998</u>	<u>111,726</u>	<u>172,107</u>

As at 31 December 2008, certain of 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	
	2008	2007	2008	2007
Listed in Hong Kong	37	3,449	3	10
Listed outside Hong Kong	68	188	68	161
	<u>105</u>	<u>3,637</u>	<u>71</u>	<u>171</u>
Unlisted	329	662	203	321
	<u>434</u>	<u>4,299</u>	<u>274</u>	<u>492</u>
Issued by corporate entities	<u>434</u>	<u>4,299</u>	<u>274</u>	<u>492</u>

During the year of 2008, certain of the 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

	Bank	
	2008	2007
Unlisted shares, at cost	<u>11,284</u>	<u>11,284</u>

(a) 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\$4,326,184,570
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.

#### (b) Acquisition

On 25 September 2007, the wholly-owned subsidiary, Hang Seng Insurance Company Limited ("HSIC"), acquired 50 per cent of the issued share capital of Hang Seng Life Limited ("HSL") from HSBC Insurance (Asia-Pacific) Holdings Limited, an indirect wholly-owned subsidiary of HSBC Holdings plc, for a consideration of HK\$2,400 million. HSIC also acquired the remaining 50 per cent of the issued share capital of HSL from the Bank for a consideration of HK\$2,400 million. After the transactions, the Group has increased its stake in its existing subsidiary HSL's issued share capital from 50 per cent to 100 per cent. The amount of goodwill arising from acquisition at Group level was HK\$329 million.

#### (c) Incorporation

Hang Seng Bank (China) Limited, a wholly-owned subsidiary of the Bank, was incorporated in mainland China in May 2007. It is registered as "Limited liability company (solely funded by Taiwan, Hong Kong or Macao corporate body)" under the PRC law.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 38 Investments in associates

	Group		Bank	
	2008	2007	2008	2007
Unlisted investments, at cost	-	-	909	-
Listed investments, at cost	-	-	1,634	1,634
Share of net assets	8,314	5,894	-	-
Goodwill	399	283	-	-
Intangible asset	157	-	-	-
	<u>8,870</u>	<u>6,177</u>	<u>2,543</u>	<u>1,634</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 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\$7,078 million (2007: HK\$5,325 million). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK\$10,599 million (2007: HK\$35,386 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 Group acquired 20 per cent of Yantai City Commercial Bank on 31 December 2008 for a consideration of HKD909 million. This investment will be equity accounted with effect from January 2009, reflecting the Group's significant influence over this associate.

The interest in Barrowgate Limited is owned by a subsidiary of the Bank. The interest in Industrial Bank Co., Ltd. and Yantai City Commercial 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 2008, the financial results of Industrial Bank Co., Ltd. was included in the financial statements based on financial statements drawn up to 30 September 2008, but taking into account any changes in the subsequent period from 1 October 2008 to 31 December 2008 that would materially affect the results. The Group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 "Investments in Associates" whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference must be no greater than three months.

On 5 February 2007, Industrial Bank Co., Ltd. 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 dilution in investment resulted in a gain of HK\$1,465 million, as represented in the Bank's increase in share of the net assets of IB, which had risen as a result of the issue of the new shares. The gain on dilution was recognised in the income statement in 2007.

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

### 38 Investments in associates *(continued)*

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>2008</b>						
100 per cent	<b>1,087,222</b>	<b>1,027,344</b>	<b>59,878</b>	<b>32,594</b>	<b>18,783</b>	<b>13,811</b>
Group's effective interest	<b>141,824</b>	<b>133,510</b>	<b>8,314</b>	<b>4,216</b>	<b>2,409</b>	<b>1,807</b>
2007						
100 per cent	920,620	877,720	42,900	21,141	13,246	7,895
Group's effective interest	118,299	112,405	5,894	2,964	1,842	1,122

There is no impairment loss of our investments in associates for the years ended 31 December 2008 and 2007.



## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 39 Investment properties

The Group's investment properties are stated at fair value as valued by independent professional valuer on at least an annual basis. The most recent valuation was performed by DTZ Debenham Tie Leung Limited, at 30 September 2008, and were adjusted for material change in the valuation as at 31 December 2008. The valuation was 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	
	2008	2007	2008	2007
At 1 January	2,581	2,732	1,708	1,557
Surplus on revaluation credited to income statement (note 22)	8	250	1	187
Transfer to assets held for sale	-	(411)	-	(46)
Transfer from premises (note 40(a))	4	10	5	10
At 31 December	<u>2,593</u>	<u>2,581</u>	<u>1,714</u>	<u>1,708</u>

#### (b) Terms of lease

	Group		Bank	
	2008	2007	2008	2007
<b>Leaseholds</b>				
Held in Hong Kong:				
- long leases (over 50 years unexpired)	1,137	1,112	467	452
- medium leases (10 to 50 years unexpired)	1,456	1,469	1,247	1,256
Held outside Hong Kong:				
- medium leases (10 to 50 years unexpired)	-	-	-	-
	<u>2,593</u>	<u>2,581</u>	<u>1,714</u>	<u>1,708</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\$18 million in 2008 (2007: HK\$21 million). Of this amount, HK\$17 million (2007: HK\$20 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	
	2008	2007	2008	2007
Less than one year	117	95	77	63
Five years or less but over one year	72	59	57	47
	<u>189</u>	<u>154</u>	<u>134</u>	<u>110</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 September 2008, and were adjusted for material change in the valuation as at 31 December 2008. 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

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 assets held for sale	-	-	-
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
Transfer to assets held for sale	-	1	1
Elimination of accumulated depreciation on revalued premises	165	-	165
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>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 40 Premises, plant and equipment (continued)

#### (a) Movement of premises, plant and equipment (continued)

2007	Group		
	Premises	Plant and equipment	Total
Cost or valuation:			
At 1 January	6,022	2,894	8,916
Exchange adjustments	6	13	19
Additions	-	414	414
Disposals	-	(135)	(135)
Elimination of accumulated depreciation on revalued premises	(145)	-	(145)
Surplus on revaluation:			
- credited to premises revaluation reserve	531	-	531
- credited to income statement (note 22)	34	-	34
Transfer to assets held for sale	(356)	-	(356)
Transfer to investment property (note 39(a))	(10)	-	(10)
At 31 December	<u>6,082</u>	<u>3,186</u>	<u>9,268</u>
Accumulated depreciation:			
At 1 January	-	(2,400)	(2,400)
Exchange adjustments	-	(5)	(5)
Charge for the year (note 17)	(147)	(201)	(348)
Written off on disposal	-	132	132
Transfer to assets held for sale	2	-	2
Elimination of accumulated depreciation on revalued premises	145	-	145
At 31 December	<u>-</u>	<u>(2,474)</u>	<u>(2,474)</u>
Net book value at 31 December	<u>6,082</u>	<u>712</u>	<u>6,794</u>
		<b>Bank</b>	
<b>2008</b>	<b>Premises</b>	<b>Plant and equipment</b>	<b>Total</b>
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>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 40 Premises, plant and equipment (continued)

#### (a) Movement of premises, plant and equipment (continued)

2007	Premises	Bank	
		Plant and equipment	Total
Cost or valuation:			
At 1 January	3,728	2,869	6,597
Exchange adjustments	-	4	4
Additions	-	311	311
Disposals	-	(117)	(117)
Elimination of accumulated depreciation on revalued premises	(92)	-	(92)
Surplus on revaluation:			
- credited to premises revaluation reserve	289	-	289
- credited to income statement	28	-	28
Transfer to assets held for sale	(289)	-	(289)
Transfer to investment property (note 39(a))	(10)	-	(10)
Transfer to subsidiaries	(76)	(140)	(216)
At 31 December	<u>3,578</u>	<u>2,927</u>	<u>6,505</u>
Accumulated depreciation:			
At 1 January	-	(2,378)	(2,378)
Exchange adjustments	-	(2)	(2)
Charge for the year	(94)	(181)	(275)
Written off on disposal	-	114	114
Transfer to assets held for sale	2	-	2
Elimination of accumulated depreciation on revalued premises	92	-	92
Transfer to subsidiaries	-	69	69
At 31 December	<u>-</u>	<u>(2,378)</u>	<u>(2,378)</u>
Net book value at 31 December	<u>3,578</u>	<u>549</u>	<u>4,127</u>

#### (b) Terms of lease

The net book value of premises comprises:

	Group		Bank	
	2008	2007	2008	2007
<b>Leaseholds</b>				
Held in Hong Kong:				
- long leases (over 50 years unexpired)	1,448	1,421	717	718
- medium leases (10 to 50 years unexpired)	4,601	4,550	2,874	2,860
Held outside Hong Kong:				
- long leases (over 50 years unexpired)	6	6	-	-
- medium leases (10 to 50 years unexpired)	106	105	-	-
	<u>6,161</u>	<u>6,082</u>	<u>3,591</u>	<u>3,578</u>

#### (c) The carrying amount of all premises which have been stated in the balance sheet would have been as follows had they been stated at cost less accumulated depreciation:

	Group		Bank	
	2008	2007	2008	2007
Cost less accumulated depreciation at 31 December	<u>1,879</u>	<u>1,928</u>	<u>725</u>	<u>747</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	
	2008	2007	2008	2007
At 1 January	565	580	565	580
Amortisation of prepaid operating lease payment (note 17)	(14)	(15)	(14)	(15)
At 31 December	<u>551</u>	<u>565</u>	<u>551</u>	<u>565</u>

### 42 Intangible assets

	Group		Bank	
	2008	2007	2008	2007
Present value of in-force long-term insurance business	2,707	2,324	-	-
Internally developed software	321	212	321	212
Acquired software	28	24	21	22
Goodwill	329	329	-	-
	<u>3,385</u>	<u>2,889</u>	<u>342</u>	<u>234</u>

The goodwill of HK\$329 million was related to the acquisition of the remaining 50 per cent of Hang Seng Life Limited from HSBC Insurance (Asia-Pacific) Holdings Limited in 2007.

#### (a) Movement of present value of in-force long-term insurance business

	Group	
	2008	2007
At 1 January	2,324	1,927
Addition from current year new business	838	624
Movement from in-force business	(425)	(165)
Other movement	(30)	(62)
At 31 December	<u>2,707</u>	<u>2,324</u>

The key assumptions used in the computation of present value of in-force long-term insurance business ("PVIF") are as follows:

	2008	2007
Risk discount rate	11.0%	11.0%
Expenses inflation	3.0%	3.0%
Average lapse rate:		
- 1st year	2.9%	6.0%
- 2nd year onwards	1.6%	2.0%

The sensitivity of PVIF valuation to changes in individual assumptions at balance sheet dates is shown in note 62(d).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 42 Intangible assets (continued)

#### (b) Goodwill

	Group		Bank	
	2008	2007	2008	2007
At 1 January	329	-	-	-
Additions	-	329	-	-
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 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 2008, there was no impairment of goodwill (2007: 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 2008, 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	
	2008	2007	2008	2007
Cost:				
At 1 January	366	244	364	244
Additions	175	127	166	125
Disposals	(9)	(5)	(8)	(5)
At 31 December	<u>532</u>	<u>366</u>	<u>522</u>	<u>364</u>
Accumulated amortisation:				
At 1 January	(130)	(101)	(130)	(101)
Charge for the year (note 17)	(60)	(33)	(58)	(33)
Written off on disposals	8	4	8	4
Transfer from plant and equipment	(1)	-	-	-
At 31 December	<u>(183)</u>	<u>(130)</u>	<u>(180)</u>	<u>(130)</u>
Net book value at 31 December	<u>349</u>	<u>236</u>	<u>342</u>	<u>234</u>

During 2008, there was no impairment on internally developed application software and acquired software (2007: Nil).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 43 Other assets

	Group		Bank	
	2008	2007	2008	2007
Items in the course of collection from other banks	4,028	6,193	4,017	6,091
Prepayments and accrued income	2,711	4,433	1,616	3,361
Assets held for sale*				
- repossessed assets	136	116	104	70
- other assets held for sale	16	83	16	83
Acceptances and endorsements	3,090	3,294	2,255	2,930
Retirement benefit assets	30	108	30	108
Other accounts	1,495	1,238	834	619
	<u>11,506</u>	<u>15,465</u>	<u>8,872</u>	<u>13,262</u>

\* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2008 (accumulated income in 2007: HK\$14 million).

There are no significant impaired, overdue or rescheduled other assets at the year-end.

### 44 Current, savings and other deposit accounts

	Group		Bank	
	2008	2007	2008	2007
Current, savings and other deposit accounts:				
- as stated in balance sheet	562,183	546,653	547,385	533,330
- structured deposits reported as trading liabilities (note 45)	29,785	24,162	24,970	23,161
	<u>591,968</u>	<u>570,815</u>	<u>572,355</u>	<u>556,491</u>
By type:				
- demand and current accounts	36,321	34,130	37,616	34,028
- savings accounts	294,556	254,976	289,296	251,191
- time and other deposits	261,091	281,709	245,443	271,272
	<u>591,968</u>	<u>570,815</u>	<u>572,355</u>	<u>556,491</u>

### 45 Trading liabilities

	Group		Bank	
	2008	2007	2008	2007
Structured certificates of deposit in issue (note 47)	3,861	3,527	3,861	3,527
Other debt securities in issue (note 47)	5,855	10,560	5,855	10,560
Structured deposits (note 44)	29,785	24,162	24,970	23,161
Short positions in securities and other	8,781	9,902	8,781	9,902
	<u>48,282</u>	<u>48,151</u>	<u>43,467</u>	<u>47,150</u>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 46 Financial liabilities designated at fair value

	Group		Bank	
	2008	2007	2008	2007
4.125% callable fixed rate subordinated notes	994	989	994	989
Liabilities to customers under investment contracts	413	509	-	-
	<u>1,407</u>	<u>1,498</u>	<u>994</u>	<u>989</u>

At 31 December 2008, 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\$6 million (2007: HK\$11 million). The accumulated amount of the change in fair value attributable to change in credit risk for the Group and the Bank was HK\$54 million (2007: HK\$12 million). The change for the year ended 31 December 2008 was HK\$42 million (2007: HK\$11 million) for the Group and the Bank.

### 47 Certificates of deposit and other debt securities in issue

	Group		Bank	
	2008	2007	2008	2007
Certificates of deposit and other debt securities in issue:				
- as stated in balance sheet	2,772	5,685	2,772	7,203
- structured certificates of deposit in issue reported as trading liabilities (note 45)	3,861	3,527	3,861	3,527
- other structured debt securities in issue reported as trading liabilities (note 45)	5,855	10,560	5,855	10,560
	<u>12,488</u>	<u>19,772</u>	<u>12,488</u>	<u>21,290</u>
By type:				
- certificates of deposit in issue	6,633	9,212	6,633	10,730
- other debt securities in issue	5,855	10,560	5,855	10,560
	<u>12,488</u>	<u>19,772</u>	<u>12,488</u>	<u>21,290</u>

### 48 Other liabilities

	Group		Bank	
	2008	2007	2008	2007
Items in the course of transmission to other banks	4,583	8,407	4,575	8,407
Accruals	2,924	3,836	2,471	3,532
Acceptances and endorsements	3,090	3,294	2,255	2,930
Retirement benefit liabilities	3,532	633	3,532	633
Other	1,319	1,680	1,977	2,319
	<u>15,448</u>	<u>17,850</u>	<u>14,810</u>	<u>17,821</u>



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

**49 Liabilities to customers under insurance contracts**

	Group					
	2008			2007		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
<b>Non-life insurance</b>						
Unearned premiums	199	(42)	157	191	(37)	154
Notified claims	162	(22)	140	147	(12)	135
Claims incurred but not reported	43	(8)	35	42	(10)	32
Other	26	(3)	23	30	(1)	29
	<b>430</b>	<b>(75)</b>	<b>355</b>	410	(60)	350
<b>Policyholders' liabilities</b>						
Life (non-linked)	43,211	(18)	43,193	32,444	(10)	32,434
Life (linked)	194	-	194	235	-	235
	<b>43,405</b>	<b>(18)</b>	<b>43,387</b>	32,679	(10)	32,669
	<b>43,835</b>	<b>(93)</b>	<b>43,742</b>	33,089	(70)	33,019

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

The movement of liabilities under insurance contracts was as follows:

**(a) Non-life insurance**

	Group		
	Gross	Reinsurance	Net
<b>2008</b>			
<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	<b>199</b>	<b>(42)</b>	<b>157</b>
<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
	<b>189</b>	<b>(22)</b>	<b>167</b>
Claims paid	(130)	33	(97)
Claims incurred	146	(41)	105
	<b>16</b>	<b>(8)</b>	<b>8</b>
At 31 December			
- notified claims	162	(22)	140
- claims incurred but not reported	43	(8)	35
	<b>205</b>	<b>(30)</b>	<b>175</b>
<b>Other</b>	<b>26</b>	<b>(3)</b>	<b>23</b>
	<b>430</b>	<b>(75)</b>	<b>355</b>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 49 Liabilities to customers under insurance contracts (continued)

#### (a) Non-life insurance (continued)

	Group		
	Gross	Reinsurance	Net
2007			
<b>Unearned premiums</b>			
At 1 January	177	(39)	138
Gross written premiums	400	(76)	324
Gross earned premiums	(386)	78	(308)
At 31 December	<u>191</u>	<u>(37)</u>	<u>154</u>
<b>Notified and incurred but not reported claims</b>			
At 1 January			
- notified claims	147	(22)	125
- claims incurred but not reported	43	(11)	32
	190	(33)	157
Claims paid	(97)	12	(85)
Claims incurred	96	(1)	95
	(1)	11	10
At 31 December			
- notified claims	147	(12)	135
- claims incurred but not reported	42	(10)	32
	<u>189</u>	<u>(22)</u>	<u>167</u>
<b>Other</b>	30	(1)	29
	<u>410</u>	<u>(60)</u>	<u>350</u>

#### (b) Policyholders' liabilities

	Group		
	Gross	Reinsurance	Net
2008			
<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>

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 49 Liabilities to customers under insurance contracts (continued)

#### (b) Policyholders' liabilities (continued)

2007	Group		
	Gross	Reinsurance	Net
<b>Life (non-linked)</b>			
At 1 January	22,382	(2)	22,380
Benefits paid	(566)	10	(556)
Claims incurred and movement in policyholders' liabilities	10,512	(18)	10,494
Exchange and other movements	116	-	116
At 31 December	<u>32,444</u>	<u>(10)</u>	<u>32,434</u>
<b>Life (linked)</b>			
At 1 January	187	-	187
Benefits paid	(41)	-	(41)
Claims incurred and movement in policyholders' liabilities	89	-	89
At 31 December	<u>235</u>	<u>-</u>	<u>235</u>
	<u>32,679</u>	<u>(10)</u>	<u>32,669</u>

### 50 Current tax and deferred tax

(a) Current tax and deferred tax assets and liabilities are represented in the balance sheet:

	Group		Bank	
	2008	2007	2008	2007
Current taxation recoverable (included in "Other assets")	25	10	-	-
Deferred taxation	<u>201</u>	<u>1</u>	<u>187</u>	<u>-</u>
	<u>226</u>	<u>11</u>	<u>187</u>	<u>-</u>
Provision for Hong Kong profits tax	91	1,471	65	1,326
Provision for taxation outside Hong Kong	3	8	1	6
Deferred taxation	<u>711</u>	<u>1,365</u>	<u>-</u>	<u>649</u>
	<u>805</u>	<u>2,844</u>	<u>66</u>	<u>1,981</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 balance sheets 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 hedges	Other	Total
<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)
Charged/(credited) 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>
<b>2007</b>							
At 1 January	74	1,112	(84)	(34)	(39)	458	1,487
Charged/(credited) to income statement (note 23(a))	24	(6)	(13)	-	-	60	65
Charged/(credited) to reserves	-	43	-	(35)	68	(264)	(188)
At 31 December	<u>98</u>	<u>1,149</u>	<u>(97)</u>	<u>(69)</u>	<u>29</u>	<u>254</u>	<u>1,364</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 hedges	Other	Total
<b>2008</b>							
At 1 January	105	820	(96)	(100)	29	(109)	649
Charged/(credited) to income statement	21	(22)	(2)	-	-	(16)	(19)
Charged/(credited) 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>
<b>2007</b>							
At 1 January	74	779	(82)	(47)	(39)	123	808
Charged/(credited) to income statement	31	21	(14)	-	-	31	69
Charged/(credited) to reserves	-	20	-	(53)	68	(263)	(228)
At 31 December	<u>105</u>	<u>820</u>	<u>(96)</u>	<u>(100)</u>	<u>29</u>	<u>(109)</u>	<u>649</u>

#### (c) Deferred tax assets not recognised

At balance sheet date, the Group has not recognised deferred tax assets in respect of tax losses of subsidiaries amounting to HK\$29 million (2007: HK\$28 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 2008 (2007: Nil).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 51 Subordinated liabilities

Nominal value	Description	Group		Bank	
		2008	2007	2008	2007
<b>Amount owed to third parties</b>					
HK\$1,500 million	Callable floating rate subordinated notes due June 2015 <sup>(1)</sup>	1,498	1,497	1,498	1,497
HK\$1,000 million	4.125% callable fixed rate subordinated notes due June 2015 <sup>(2)</sup>	994	989	994	989
US\$450 million	Callable floating rate subordinated notes due July 2016 <sup>(3)</sup>	3,478	3,497	3,478	3,497
US\$300 million	Callable floating rate subordinated notes due July 2017 <sup>(4)</sup>	2,318	2,332	2,318	2,332
<b>Amount owed to HSBC Group undertakings</b>					
US\$260 million	Callable floating rate subordinated loan debt due December 2015 <sup>(5)</sup>	2,015	2,028	2,015	2,028
		<u>10,303</u>	<u>10,343</u>	<u>10,303</u>	<u>10,343</u>
Representing:					
- measured at amortised cost		9,309	9,354	9,309	9,354
- designated at fair value (note 46)		994	989	994	989
		<u>10,303</u>	<u>10,343</u>	<u>10,303</u>	<u>10,343</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 (2007: HK\$11,000 million) divided into 2,200 million shares (2007: 2,200 million shares) of HK\$5 each.

	2008	2007
Issued and fully paid:		
1,911,842,736 shares (2007: 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 (2007: Nil).

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 53 Reserves

2008

	Group	Bank	Associates
Retained profits	32,518	15,563	4,154
Premises revaluation reserve	3,711	2,503	-
Cash flow hedges reserve	562	528	-
Available-for-sale investments reserve:			
- on debt securities	(4,137)	(2,532)	(43)
- on equity securities	314	177	-
Capital redemption reserve	99	99	-
Other reserves	3,264	420	2,217
Total reserves	<u>36,331</u>	<u>16,758</u>	<u>6,328</u>
<b>Retained profits</b>			
At 1 January	32,873	19,211	2,634
Exchange and other adjustments	1	2	-
Profit attributable to shareholders	14,099	10,830	1,807
Dividends	(12,045)	(12,045)	(287)
Transfer from premises revaluation reserve:			
- depreciation on revaluation surplus	94	69	-
- realisation of revaluation surplus on disposal of premises	26	26	-
Actuarial losses on defined benefit plans	(2,518)	(2,518)	-
Effect of decrease in tax rate in deferred tax balance at 1 January	(12)	(12)	-
At 31 December	<u>32,518</u>	<u>15,563</u>	<u>4,154</u>
<b>Premises revaluation reserve, net of tax</b>			
At 1 January	3,639	2,522	-
Exchange adjustments	2	-	-
Unrealised surplus on revaluation	143	42	-
Transfer to retained profits:			
- depreciation on revaluation surplus	(94)	(69)	-
- realisation of revaluation surplus on disposal of premises	(22)	(22)	-
Effect of decrease in tax rate in deferred tax balance at 1 January	43	30	-
At 31 December	<u>3,711</u>	<u>2,503</u>	<u>-</u>
<b>Cash flow hedges reserve, net of tax</b>			
At 1 January	144	137	-
Amounts recognised in equity during the year	735	688	-
Amounts transferred from equity			
- to the income statement for the year	(317)	(297)	-
- to initial carrying amount of non-financial hedged items	-	-	-
At 31 December	<u>562</u>	<u>528</u>	<u>-</u>
<b>Available-for-sale investments reserve, net of tax</b>			
At 1 January	1,892	(95)	12
Amounts recognised in equity during the year	(5,272)	(1,742)	(55)
Transfer to income statement:			
- on impairment	543	141	-
- change in fair value of hedged items	(418)	(397)	-
- on disposal	(568)	(262)	-
At 31 December	<u>(3,823)</u>	<u>(2,355)</u>	<u>(43)</u>
<b>Capital redemption reserve</b>			
At 1 January and 31 December	<u>99</u>	<u>99</u>	<u>-</u>
<b>Other reserves</b>			
At 1 January	2,514	298	1,897
Foreign exchange reserve	622	(5)	320
Share based payment reserve	127	127	-
Other	1	-	-
At 31 December	<u>3,264</u>	<u>420</u>	<u>2,217</u>
Total reserves at 31 December	<u>36,331</u>	<u>16,758</u>	<u>6,328</u>

Amounts transferred to the income statement in respect of cash flow hedges include HK\$316 million and HK\$1 million taken to "Net interest income" and "Trading income" respectively.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 53 Reserves (continued)

2007

	Group	Bank	Associates
Retained profits	32,873	19,211	2,634
Premises revaluation reserve	3,639	2,522	-
Cash flow hedges reserve	144	137	-
Available-for-sale investments reserve:			
- on debt securities	(841)	(520)	12
- on equity securities	2,733	425	-
Capital redemption reserve	99	99	-
Other reserves	2,514	298	1,897
Total reserves	<u>41,161</u>	<u>22,172</u>	<u>4,543</u>
<b>Retained profits</b>			
At 1 January	29,044	17,281	1,719
Exchange and other adjustments	-	-	-
Profit attributable to shareholders	18,242	15,122	2,587
Dividends	(12,045)	(12,045)	(207)
Transfer from premises revaluation reserve:			
- depreciation on revaluation surplus	80	61	-
- realisation of revaluation surplus on disposal of premises	260	172	-
Actuarial losses on defined benefit plans	(1,243)	(1,243)	-
Transfer to subsidiaries	-	(137)	-
Transfer to other reserves on dilution gain of investment in associate	(1,465)	-	(1,465)
At 31 December	<u>32,873</u>	<u>19,211</u>	<u>2,634</u>
<b>Premises revaluation reserve, net of tax</b>			
At 1 January	3,491	2,486	-
Unrealised surplus on revaluation	443	239	-
Transfer to retained profits:			
- depreciation on revaluation surplus	(80)	(61)	-
- realisation of revaluation surplus on disposal of premises	(215)	(142)	-
At 31 December	<u>3,639</u>	<u>2,522</u>	<u>-</u>
<b>Cash flow hedges reserve, net of tax</b>			
At 1 January	(220)	(192)	-
Amounts recognised in equity during the year	146	134	-
Amounts transferred from equity			
- to the income statement for the year	218	195	-
- to initial carrying amount of non-financial hedged items	-	-	-
At 31 December	<u>144</u>	<u>137</u>	<u>-</u>
<b>Available-for-sale investments reserve, net of tax</b>			
At 1 January	923	(165)	10
Amounts recognised in equity during the year	1,594	253	2
Transfer to income statement:			
- on impairment	-	-	-
- change in fair value of hedged items	(181)	(159)	-
- on disposal	(444)	(24)	-
At 31 December	<u>1,892</u>	<u>(95)</u>	<u>12</u>
<b>Capital redemption reserve</b>			
At 1 January and 31 December	<u>99</u>	<u>99</u>	<u>-</u>
<b>Other reserves</b>			
At 1 January	452	318	125
Transfer from income statement on dilution gain of investment in associate	1,465	-	1,465
Foreign exchange reserve	527	(90)	307
Share based payment reserve	70	70	-
At 31 December	<u>2,514</u>	<u>298</u>	<u>1,897</u>
Total reserves at 31 December	<u>41,161</u>	<u>22,172</u>	<u>4,543</u>

Amounts transferred from the income statement in respect of cash flow hedges include HK\$218 million taken from "Net interest income".

## 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

In accordance with the HKMA guideline, *Impact of the New Hong Kong Accounting Standards on Authorised Institutions' Capital Base and Regulatory Reporting*, the Group has earmarked a "regulatory reserve" of HK\$854 million (2007: HK\$911 million) from retained profits in order to satisfy the provisions of the Hong Kong Banking Ordinance for prudential supervision purposes in respect of losses which the Group will or may incur on loans and advances in addition to impairment losses recognised. Movements in the regulatory reserve are earmarked directly through retained profits and in consultation with the HKMA.

#### 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 balance sheet at 31 December 2008 (31 December 2007: HK\$26 million).

#### Cash flow hedges 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 investments reserve

The available-for-sale investments 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 hedges reserve", "Available-for-sale investments 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

	2008	2007
Operating profit	13,725	17,789
Net interest income	(16,232)	(14,719)
Dividend income	(82)	(52)
Loan impairment charges and other credit risk provisions	2,776	576
Impairment of available-for-sale equity securities	284	-
Depreciation	432	348
Amortisation of intangible assets	60	33
Amortisation of available-for-sale investments	(398)	(838)
Amortisation of held-to-maturity debt securities	1	(1)
Advances written off net of recoveries	(400)	(429)
Interest received	16,232	25,530
Interest paid	(9,249)	(19,208)
<b>Operating profit before changes in working capital</b>	<b>7,149</b>	<b>9,029</b>
Change in treasury bills and certificates of deposit with original maturity more than three months	14,016	(5,958)
Change in placings with and advances to banks maturing after one month	(2,895)	4,324
Change in trading assets	(100,363)	1,160
Change in financial assets designated at fair value	(276)	362
Change in derivative financial instruments	7,848	349
Change in advances to customers	(21,766)	(29,150)
Change in other assets	(3,474)	(11,612)
Change in financial liabilities designated at fair value	5	2
Change in current, savings and other deposit accounts	15,530	63,832
Change in deposits from banks	(8,300)	2,056
Change in trading liabilities	131	(11,942)
Change in certificates of deposit and other debt securities in issue	(2,913)	(1,910)
Change in other liabilities	7,150	10,963
Elimination of exchange differences and other non-cash items	4,542	(7,892)
<b>Cash (used in)/generated from operating activities</b>	<b>(83,616)</b>	<b>23,613</b>
Taxation paid	(3,214)	(2,543)
<b>Net cash (outflow)/inflow from operating activities</b>	<b>(86,830)</b>	<b>21,070</b>

#### (b) Analysis of the balances of cash and cash equivalents

	2008	2007
Cash and balances with banks and other financial institutions	24,822	16,864
Placings with and advances to banks and other financial institutions maturing within one month	44,572	89,895
Treasury bills	6,722	4,114
Certificates of deposit	-	2,601
	<b>76,116</b>	<b>113,474</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\$5,085 million at 31 December 2008 (2007: HK\$9,171 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 contingent liabilities and commitments. 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 balance sheet 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\$3,090 million (2007: HK\$3,294 million) and HK\$2,255 million (2007: HK\$2,930 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 2008 were calculated based on the "foundation internal ratings-based approach" and the risk-weighted assets for 2007 were calculated based on the "standardised (credit risk) approach". The figures are therefore not strictly comparable.

	Group			Bank		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
<b>2008</b>						
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 2008 were HK\$10,444 million and HK\$13,264 million respectively.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 55 Contingent liabilities and commitments (continued)

2007	Group			Bank		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
Direct credit substitutes	4,651	4,651	3,638	4,651	4,651	3,638
Transaction-related contingencies	812	406	398	511	256	249
Trade-related contingencies	10,274	2,055	2,045	9,255	1,851	1,848
Forward asset purchases	115	115	115	115	115	115
Undrawn formal standby facilities, credit lines and other commitments to lend:						
- not unconditionally cancellable						
-- not more than one year	20,253	4,051	4,051	18,801	3,760	3,760
-- more than one year	15,973	7,986	6,752	14,771	7,385	6,151
- unconditionally cancellable	145,641	-	-	136,840	-	-
	<u>197,719</u>	<u>19,264</u>	<u>16,999</u>	<u>184,944</u>	<u>18,018</u>	<u>15,761</u>

### 56 Assets pledged as security for liabilities

At 31 December 2008, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements amounted to HK\$9,807 million and HK\$8,766 million respectively (Group and Bank in 2007: HK\$8,410 million). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK\$10,110 million and HK\$9,069 million respectively (Group and Bank in 2007: HK\$8,474 million) 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	
	2008	2007	2008	2007
Expenditure authorised and contracted for	<u>141</u>	<u>350</u>	<u>138</u>	<u>320</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	
	2008	2007	2008	2007
Within one year	398	396	284	311
Between one and five years	497	618	361	500
Over five years	2	53	-	46
	<u>897</u>	<u>1,067</u>	<u>645</u>	<u>857</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 was 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 2008 was 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 balance sheet 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 balance sheets are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<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 balance sheet (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>
<b>2007</b>			
Present value of funded obligations (note 59(a)(iii))	(5,722)	(188)	(3)
Fair value of scheme assets (note 59(a)(iv))	5,089	267	32
Net (liabilities)/assets recognised in the balance sheet (note 59(a)(v))	<u>(633)</u>	<u>79</u>	<u>29</u>
Reported as "Assets"	-	79	29
Reported as "Liabilities"	<u>(633)</u>	<u>-</u>	<u>-</u>
	<u>(633)</u>	<u>79</u>	<u>29</u>
Obligations covered by scheme assets (%)	<u>89</u>	<u>142</u>	<u>1,067</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 recommendations of an actuary.

## 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 89 per cent (2007: 120 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting deficit amounted to HK\$453 million (surplus in 2007: HK\$857 million). On a wind-up basis, the actuarial value of the scheme assets represented 90 per cent (2007: 134 per cent) of the members' vested benefits, based on salaries at that date, and the resulting deficit amounted to HK\$379 million (surplus in 2007: HK\$1,288 million).

(ii) The composition of the scheme assets are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2008</b>			
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>
<b>2007</b>			
Equity	1,886	37	-
Bonds	2,291	204	-
Certificates of deposit issued by the Bank	4	-	-
Ordinary shares issued by ultimate holding company	65	-	-
Other	843	26	32
	<u>5,089</u>	<u>267</u>	<u>32</u>

(iii) Change in the present value of scheme obligations

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<b>2008</b>			
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>
<b>2007</b>			
At 1 January	3,727	175	3
Current service cost	194	-	-
Interest cost	137	6	-
Actuarial losses	1,900	22	1
Benefits paid	(236)	(15)	(1)
At 31 December	<u>5,722</u>	<u>188</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>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>
<b>2007</b>			
At 1 January	4,454	242	32
Contributions by the Bank	142	8	-
Expected return on scheme assets	336	9	1
Experience gains	393	23	-
Benefits paid	(236)	(15)	(1)
At 31 December	<u>5,089</u>	<u>267</u>	<u>32</u>

The Group and the Bank expect to make HK\$400 million of contributions to defined benefit schemes during the following year (2007: HK\$149 million).

##### (v) Movements in the net assets recognised in the balance sheets are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
<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>
<b>2007</b>			
At 1 January	727	67	29
Contributions by the Bank	142	8	-
Net income recognised in the income statement (note 59(a)(vi))	5	3	1
Net actuarial (losses)/gains	(1,507)	1	(1)
At 31 December	<u>(633)</u>	<u>79</u>	<u>29</u>
Experience losses on scheme liabilities	(197)	(15)	-
Experience gains on scheme assets	393	23	-
Losses from change in actuarial assumptions	(1,703)	(7)	(1)
Net actuarial (losses)/gains	<u>(1,507)</u>	<u>1</u>	<u>(1)</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>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>
<b>2007</b>			
Current service cost	(194)	-	-
Interest cost	(137)	(6)	-
Expected return on scheme assets	336	9	1
Net income for the year (note 17)	<u>5</u>	<u>3</u>	<u>1</u>
Actual return on scheme assets	<u>729</u>	<u>32</u>	<u>1</u>

The net actuarial losses recognised in the Group's retained profit during 2008 in respect of defined benefit schemes were HK\$2,529 million (net actuarial losses of HK\$1,243 million during 2007). The total cumulative amount of actuarial losses recognised in the retained profit was HK\$3,479 million (2007: the cumulative amount of actuarial losses was HK\$950 million). The total effect of the limit on schemes surpluses in 2008 and 2007 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>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	-
<b>2007</b>	%	%	%
Discount rate	3.5	3.5	3.5
Expected rate of return on scheme assets	7.5	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				
	2008	2007	2006	2005	2004
Defined benefit obligations	7,183	5,913	3,905	3,742	3,849
Plan assets	3,681	5,388	4,728	4,199	3,989
Net (deficits)/surpluses	(3,502)	(525)	823	457	140
Experience gains/(losses) on scheme liabilities	260	(212)	(36)	19	(60)
Experience (losses)/gains on scheme assets	(1,989)	416	413	68	80
(Losses)/gains from change in actuarial assumptions	(1,287)	(1,711)	(113)	104	(181)

#### (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:

	2008	2007
Amounts charged to the income statement (note 17)	<u>69</u>	<u>56</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 (2007: 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 (2007: 20 per cent) discount to the market value at the date of grant.

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



## NOTES 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 balance sheet date, are as follows:

	2008		2007	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	6.43	1,922	10.63	3,408
Granted in the year	-	-	-	-
Exercised in the year	6.36	(1,235)	6.46	(1,318)
Lapsed in the year	6.43	(144)	10.63	(168)
Outstanding at 31 December	6.55	<u>543</u>	6.43	<u>1,922</u>
Exercisable at 31 December	6.68	<u>2</u>	-	-

The weighted average share price at the date of exercise for share options exercised during the year was £6.36 (2007: £6.46).

The options outstanding at the year end had an exercise price in the range of £6.47 to £6.68 (2007: £5.35 to £6.68), and a weighted average remaining contractual life of 1.45 years (2007: 1.57 years).

	2008		2007	
	Weighted average exercise price HK\$	Number ('000)	Weighted average exercise price HK\$	Number ('000)
Outstanding at 1 January	106.73	3,363	103.44	1,617
Granted in the year	106.25	2,034	108.45	2,347
Exercised in the year	108.45	(584)	103.44	(350)
Lapsed in the year	106.73	(2,517)	103.44	(251)
Outstanding at 31 December	106.14	<u>2,296</u>	106.73	<u>3,363</u>
Exercisable at 31 December	-	-	-	-

The weighted average share price at the date of exercise for share options exercised during the year was HK\$108.45 (2007: HK\$103.44).

The options outstanding at the year end had an exercise price in the range of HK\$103.44 to HK\$108.45 (2007 HK\$103.44 to HK\$108.45), and a weighted average remaining contractual life of 2.42 years (2007: 2.97 years).

The weighted average fair value of options granted during the year was HK\$29.42 (2007: HK\$33.55).

## 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 balance sheet date, are as follows:

	2008		2007	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	7.89	2,976	7.86	3,465
Exercised in the year	7.03	(158)	7.48	(356)
Lapsed in the year	7.89	(71)	7.86	(133)
Outstanding at 31 December	7.93	<u>2,747</u>	7.89	<u>2,976</u>
Exercisable at 31 December	7.93	<u>2,747</u>	7.89	<u>2,976</u>

The options outstanding at the year end had an exercise price in the range of £6.38 to £8.71 ( 2007: £6.38 to £8.71), and a weighted average remaining contractual life of 4.58 years ( 2007: 5.51 years).

The weighted average share price at the date of exercise for share options exercised during the year was £7.99 (2007: £9.03).

#### (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. 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>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\$)	106.25	106.25	106.25
<b>2007</b>			
Risk-free interest rate (%)	4.9	4.5	4.5
Expected life (years)	1	3	5
Expected volatility (%)	17	17	17
Share price at grant date (HK\$)	108.45	108.45	108.45

## 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.

	2008	2007
	Number ('000)	Number ('000)
Outstanding at 1 January	500	302
Additions during the year	462	231
Released in the year	(45)	(33)
Lapsed in the year	-	-
Outstanding at 31 December	<u>917</u>	<u>500</u>

The closing price of the HSBC Holdings plc share at 31 December 2008 was £6.62 (2007: £8.42).

The weighted average remaining vesting period as at 31 December 2008 was 1.86 years (2007: 2.00 years).

#### (e) Employee expenses

During 2008, HK\$109 million was charged to the income statement in respect of share-based payment transactions settled in equity (2007: HK\$88 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 2008, 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. On 25 September 2007 ("Completion Date"), the acquisition of 50 per cent of the issued share capital of Hang Seng Life Limited ("HSL") from a fellow subsidiary by Hang Seng Insurance Company Limited ("HSIC"), a wholly-owned subsidiary of the Bank, for a consideration of HK\$2,400 million was completed.

During 2007, 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 the HSIC. 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	
	2008	2007	2008	2007	2008	2007
Interest income	315	207	57	111	1	9
Interest expense	(314)	(863)	(12)	(25)	(13)	(11)
Other operating (expense)/income	(52)	27	12	(5)	2	-
Operating expenses*	(696)	(694)	(388)	(290)	(13)	(15)
<b>Amounts due from:</b>						
Cash and balances with banks and other financial institutions	6,765	341	267	520	245	20
Placings with and advances to banks and other financial institutions	10,899	1,802	-	3,975	-	-
Derivative financial instruments	602	258	33	128	-	7
Financial assets designated at fair value	3,545	3,672	-	-	-	-
Advances to customers	-	-	-	-	233	233
Financial investments	692	909	-	-	-	-
Other assets	108	73	118	55	3	7
	<u>22,611</u>	<u>7,055</u>	<u>418</u>	<u>4,678</u>	<u>481</u>	<u>267</u>
<b>Amounts due to:</b>						
Current, savings and other deposit accounts	36	1,779	141	151	51	63
Deposits from banks	5,478	3,406	-	65	441	366
Derivative financial instruments	7,390	1,720	35	53	-	12
Subordinated liabilities	2,015	2,028	-	-	-	-
Other liabilities	194	243	80	73	-	-
	<u>15,113</u>	<u>9,176</u>	<u>256</u>	<u>342</u>	<u>492</u>	<u>441</u>
<b>Derivative contracts:</b>						
Contract amount	136,269	96,684	8,593	14,284	-	716

\* 2008 Operating expenses included payment of HK\$127 million (2007: HK\$87 million) of software costs which were capitalised as intangible assets in the balance sheet 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)

	Bank							
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Subsidiaries		Associates	
	2008	2007	2008	2007	2008	2007	2008	2007
<b>Amounts due from:</b>								
Cash and balances with banks and other financial institutions	6,724	256	261	520	-	-	-	-
Placings with and advances to banks and other financial institutions	6,192	499	-	3,975	-	-	-	-
Derivative financial instruments	592	222	33	128	62	-	-	-
Financial assets designated at fair value	-	-	-	-	-	-	-	-
Advances to customers	-	-	-	-	-	-	-	-
Amounts due from subsidiaries	-	-	-	-	84,907	102,806	-	-
Financial investments	-	134	-	-	-	-	-	-
Other assets	59	23	94	33	-	-	3	7
	<u>13,567</u>	<u>1,134</u>	<u>388</u>	<u>4,656</u>	<u>84,969</u>	<u>102,806</u>	<u>3</u>	<u>7</u>
<b>Amounts due to:</b>								
Current, savings and other deposit accounts	36	1,779	141	151	-	-	51	63
Deposits from banks	4,958	2,183	-	65	-	-	-	-
Derivative financial instruments	7,379	1,700	35	53	74	-	-	-
Subordinated liabilities	2,015	2,028	-	-	-	-	-	-
Amounts due to subsidiaries	-	-	-	-	8,575	5,365	-	-
Other liabilities	162	194	75	63	-	-	-	-
	<u>14,550</u>	<u>7,884</u>	<u>251</u>	<u>332</u>	<u>8,649</u>	<u>5,365</u>	<u>51</u>	<u>63</u>
<b>Derivative contracts:</b>								
Contract amount	135,420	94,489	8,593	14,284	3,636	948	-	-

## 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	
	2008	2007	2008	2007
Employee benefits	51	35	51	35
Post-employment benefits	5	5	5	5
Share-based payments	8	3	8	3
	<u>64</u>	<u>43</u>	<u>64</u>	<u>43</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	
	2008	2007	2008	2007
Interest received	444	610	432	589
Interest paid	137	294	137	294
Fees and exchange income received	20	16	20	16
Loans and advances	17,749	13,472	16,385	12,041
Deposits	5,348	8,611	5,348	8,611
Undrawn commitments	4,182	4,530	4,182	4,403
Maximum aggregate amount of loans and advances during the year	21,020	18,632	19,424	16,898

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	
	2008	2007	2008	2007
Aggregate amount of relevant transactions outstanding at 31 December	<u>50</u>	<u>88</u>	<u>45</u>	<u>83</u>
Maximum aggregate amount of relevant transactions during the year	<u>174</u>	<u>154</u>	<u>168</u>	<u>148</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 note 38 and note 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 2008 was HK\$233 million (2007: HK\$233 million).

The Bank has entered into Technical Support and Assistance Agreement with Industrial Bank Co., Ltd. ("IB") to provide technical support and assistance in relation to various banking operations and businesses of IB. The Bank has also assisted IB in managing and growing the credit card business, and provided support in the issuance of dual-logo credit cards.

#### (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 2008 amounted to HK\$411 million comprising HK\$371 million relating to share option schemes and HK\$40 million relating to share award schemes (2007: HK\$284 million relating to share option schemes only).

#### (g) Employee retirement benefits

At 31 December 2008, defined benefit scheme assets amounted to HK\$1,387 million (2007: HK\$1,127 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK\$4 million (2007: 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 initiatives and due diligence 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 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 categorize 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.

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 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	
	2008	2007	2008	2007
Cash and balances with banks and other financial institutions	24,822	16,864	22,071	13,362
Placings with and advances to banks and other financial institutions	69,579	113,029	38,097	86,137
Trading assets	108,389	10,390	107,775	8,904
Financial assets designated at fair value	7,798	13,892	830	1,238
Derivative financial instruments	7,104	4,702	6,910	4,411
Advances to customers	329,121	308,356	280,255	255,413
Financial investments	181,159	244,294	112,000	172,599
Amounts due from subsidiaries	-	-	84,907	102,806
Other assets	11,123	15,083	8,627	12,940
Financial guarantees and other credit related contingent liabilities	8,744	12,037	8,682	11,651
Loan commitments and other credit related commitments	285,507	276,227	273,210	262,071
	<u>1,033,346</u>	<u>1,014,874</u>	<u>943,364</u>	<u>931,532</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, as follows:

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	EL9 to EL10 and all EL1 to EL8 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 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: have been assessed, individually or collectively, as impaired.

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.

The Group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL 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.

## 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 an underlying 22-grade scale of obligor probability of default. These scales are used Group-wide for all distinct customers, depending on which Basel II approach is adopted for the assets in question. The EL ("Expected Loss") scale summarises an underlying 10-grade, granular scale combining Basel II PD and LGD factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classification 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 year 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 profit and loss statement. Consequently, all such balances are reported under "neither past due nor impaired".

#### *Distribution of financial instruments by credit quality*

	Group						Total
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	
	Strong	Medium	Sub- standard				
<b>2008</b>							
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			Group			Total
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	
2007							
Items in the course of collection from other banks	6,193	-	-	-	-	-	6,193
Trading assets							
- treasury and eligible bills*	6,303	-	-	-	-	-	6,303
- debt securities*	3,911	147	-	-	-	-	4,058
- loans and advances to banks	-	22	-	-	-	-	22
- loans and advances to customers	-	5	-	-	-	-	5
	<u>10,214</u>	<u>174</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>10,388</u>
Financial assets designated at fair value							
- treasury and eligible bills*	-	-	-	-	-	-	-
- debt securities*	7,721	191	-	-	-	-	7,912
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-	-
	<u>7,721</u>	<u>191</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>7,912</u>
Derivatives	3,797	903	2	-	-	-	4,702
Loans and advances held at amortised cost							
- loans and advances to banks	115,474	11,111	-	-	-	-	126,585
- loans and advances to customers	188,776	107,672	5,381	6,319	1,261	(1,053)	308,356
	<u>304,250</u>	<u>118,783</u>	<u>5,381</u>	<u>6,319</u>	<u>1,261</u>	<u>(1,053)</u>	<u>434,941</u>
Financial investments							
- treasury and similar bills	3,089	-	-	-	-	-	3,089
- debt securities	219,922	16,984	-	-	-	-	236,906
	<u>223,011</u>	<u>16,984</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>239,995</u>
Other assets							
- acceptances and endorsements	1,140	2,056	98	-	-	-	3,294
- other	4,334	1,234	16	12	-	-	5,596
	<u>5,474</u>	<u>3,290</u>	<u>114</u>	<u>12</u>	<u>-</u>	<u>-</u>	<u>8,890</u>

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

**62 Financial risk management** (continued)

(a) **Credit risk** (continued)

(ii) **Credit quality** (continued)

	<u>Neither past due nor impaired</u>			Bank			Total
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	
<b>2008</b>							
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>

## 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	
2007							
Items in the course of collection from other banks	6,091	-	-	-	-	-	6,091
Trading assets							
- treasury and eligible bills*	5,645	-	-	-	-	-	5,645
- debt securities*	3,083	147	-	-	-	-	3,230
- loans and advances to banks	-	22	-	-	-	-	22
- loans and advances to customers	-	5	-	-	-	-	5
	<u>8,728</u>	<u>174</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>8,902</u>
Financial assets designated at fair value							
- treasury and eligible bills*	-	-	-	-	-	-	-
- debt securities*	1,238	-	-	-	-	-	1,238
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-	-
	<u>1,238</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,238</u>
Derivatives	3,536	873	2	-	-	-	4,411
Loans and advances held at amortised cost							
- loans and advances to banks	90,052	6,329	-	-	-	-	96,381
- loans and advances to customers	159,505	86,495	4,923	4,680	766	(956)	255,413
	<u>249,557</u>	<u>92,824</u>	<u>4,923</u>	<u>4,680</u>	<u>766</u>	<u>(956)</u>	<u>351,794</u>
Financial investments							
- treasury and similar bills	3,089	-	-	-	-	-	3,089
- debt securities	156,656	12,362	-	-	-	-	169,018
	<u>159,745</u>	<u>12,362</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>172,107</u>
Other assets							
- acceptances and endorsements	1,011	1,822	97	-	-	-	2,930
- other	3,140	757	10	12	-	-	3,919
	<u>4,151</u>	<u>2,579</u>	<u>107</u>	<u>12</u>	<u>-</u>	<u>-</u>	<u>6,849</u>

\* 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 the profit and loss statement. Consequently, all such balances are reported under "neither past due nor impaired".

## 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>2008</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>
	<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>
	<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*	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>
	<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>
	<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>
	<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)

	Group					Total
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	
2007						
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	4,884	459	865	80	31	6,319
	<u>4,884</u>	<u>459</u>	<u>865</u>	<u>80</u>	<u>31</u>	<u>6,319</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	9	2	1	-	-	12
	<u>9</u>	<u>2</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>12</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>2008</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*	<b>3,843</b>	<b>648</b>	<b>173</b>	<b>28</b>	<b>29</b>	<b>4,721</b>
	<u><b>3,843</b></u>	<u><b>648</b></u>	<u><b>173</b></u>	<u><b>28</b></u>	<u><b>29</b></u>	<u><b>4,721</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>7</b>	<b>1</b>	-	-	-	<b>8</b>
	<u><b>7</b></u>	<u><b>1</b></u>	<u>-</u>	<u>-</u>	<u>-</u>	<u><b>8</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	
2007						
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*	3,991	437	203	18	31	4,680
	<u>3,991</u>	<u>437</u>	<u>203</u>	<u>18</u>	<u>31</u>	<u>4,680</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	9	2	1	-	-	12
	<u>9</u>	<u>2</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>12</u>

\* 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 2008 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)*

Other than gross loans and advances, no financial assets was past due but not impaired at the balance sheet dates of 2008 and 2007.

*Renegotiated loans that would otherwise be past due or impaired*

	<b>Group</b>		<b>Bank</b>	
	<b>2008</b>	2007	<b>2008</b>	2007
Renegotiated loans that would otherwise be past due or impaired	<u><b>296</b></u>	<u>247</u>	<u><b>228</b></u>	<u>158</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>2008</b>	2007	<b>2008</b>	2007
Nature of assets:				
Residential properties	<b>115</b>	198	<b>103</b>	114
Commercial and industrial properties	<b>14</b>	-	<b>14</b>	-
Other	<b>1</b>	-	<b>1</b>	-
	<u><b>130</b></u>	<u>198</u>	<u><b>118</b></u>	<u>114</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>2008</b>	2007
The Bank and its subsidiaries designated by the HKMA	<u><b>46.4%</b></u>	<u>52.9%</u>

The following tables give the undiscounted cash-flow projection of the Group's financial liabilities including interest payable and undrawn commitments at balance sheet date 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 balance sheet date are reported under the column "repayable on demand". Liabilities in trading portfolios are not included in this analysis as they are typically held for short periods of time.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (b) Liquidity risk (continued)

	Group					Total
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	
<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
Derivative financial instruments	-	37	(46)	248	52	291
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>369,204</u>	<u>197,309</u>	<u>18,844</u>	<u>13,547</u>	<u>927</u>	<u>599,831</u>
Commitments:						
Documentary credits and short term related transactions	270	2,731	939	6	10	3,956
Forward asset purchases	253	16	43	-	-	312
Undrawn formal standby facilities, credit lines and other commitments to lend	2,759	29,340	11,224	154,772	-	198,095
	<u>3,282</u>	<u>32,087</u>	<u>12,206</u>	<u>154,778</u>	<u>10</u>	<u>202,363</u>

	Group					Total
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	
<b>At 31 December 2007</b>						
Current, savings and other deposit accounts	312,458	221,304	13,320	1,012	359	548,453
Deposits from banks	1,793	15,741	2,395	-	-	19,929
Financial liabilities designated at fair value	41	10	31	1,062	468	1,612
Derivative financial instruments	-	116	(2)	73	17	204
Certificates of deposit and other debt securities in issue	-	85	3,023	2,996	-	6,104
Other financial liabilities	8,003	5,576	1,261	42	99	14,981
Subordinated liabilities	-	122	366	10,607	-	11,095
	<u>322,295</u>	<u>242,954</u>	<u>20,394</u>	<u>15,792</u>	<u>943</u>	<u>602,378</u>
Commitments:						
Documentary credits and short term related transactions	484	4,863	1,432	17	15	6,811
Forward asset purchases	231	110	5	-	-	346
Undrawn formal standby facilities, credit lines and other commitments to lend	2,863	39,643	29,329	127,957	-	199,792
	<u>3,578</u>	<u>44,616</u>	<u>30,766</u>	<u>127,974</u>	<u>15</u>	<u>206,949</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	Three months to one year	One year to five years	Over five years	
<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
Derivative financial instruments	-	38	(48)	245	52	287
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>367,745</u>	<u>192,599</u>	<u>14,903</u>	<u>12,794</u>	<u>1,310</u>	<u>589,351</u>
Commitments:						
Documentary credits and short term related transactions	265	2,619	933	6	10	3,833
Forward asset purchases	-	16	43	-	-	59
Undrawn formal standby facilities, credit lines and other commitments to lend	-	28,067	6,777	153,841	-	188,685
	<u>265</u>	<u>30,702</u>	<u>7,753</u>	<u>153,847</u>	<u>10</u>	<u>192,577</u>

	Bank					Total
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	
<b>At 31 December 2007</b>						
Current, savings and other deposit accounts	307,976	214,085	11,842	638	359	534,900
Deposits from banks	1,502	10,401	300	-	-	12,203
Financial liabilities designated at fair value	-	10	31	1,062	-	1,103
Derivative financial instruments	-	47	3	72	17	139
Certificates of deposit and other debt securities in issue	-	1,598	3,039	2,996	-	7,633
Amounts due to subsidiaries	3,147	2,220	-	-	-	5,367
Other financial liabilities	7,918	6,077	1,146	2	-	15,143
Subordinated liabilities	-	122	366	10,607	-	11,095
	<u>320,543</u>	<u>234,560</u>	<u>16,727</u>	<u>15,377</u>	<u>376</u>	<u>587,583</u>
Commitments:						
Documentary credits and short term related transactions	423	4,274	1,432	17	15	6,161
Forward asset purchases	-	110	5	-	-	115
Undrawn formal standby facilities, credit lines and other commitments to lend	1,375	35,849	24,763	126,350	-	188,337
	<u>1,798</u>	<u>40,233</u>	<u>26,200</u>	<u>126,367</u>	<u>15</u>	<u>194,613</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 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, 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.

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 2008 and 2007 are shown in the table below.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (c) Market risk (continued)

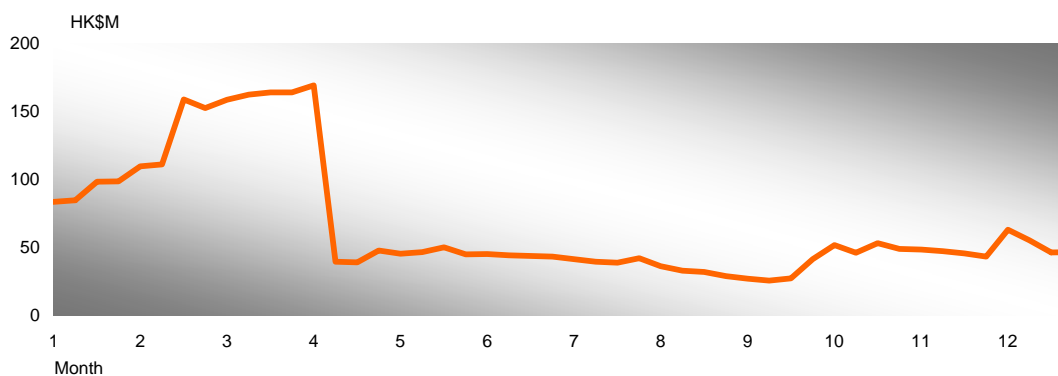
Value at risk

	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

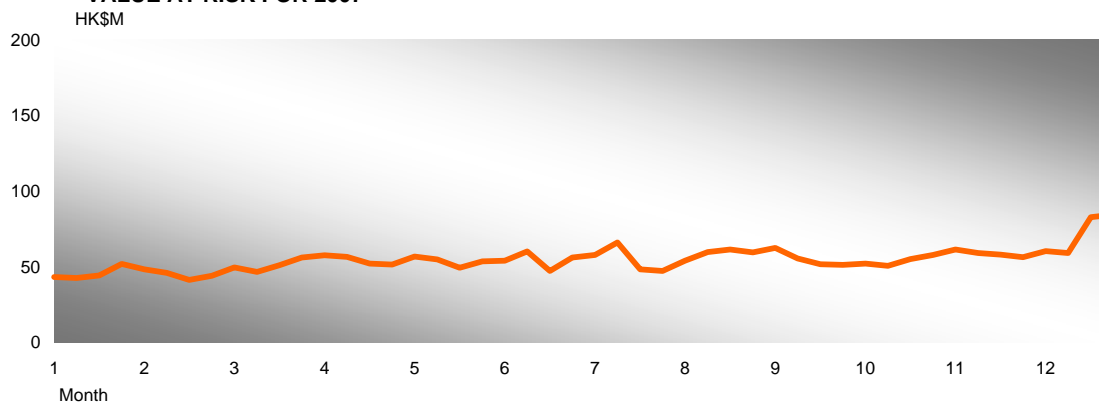
	At 31 December 2007 (restated)	Minimum during the year (restated)	Maximum during the year (restated)	Average for the year (restated)
VAR for all interest rate risk and foreign exchange risk	86	39	86	54
VAR for foreign exchange risk (trading)	6	1	15	6
VAR for interest rate risk:				
- trading	2	2	9	5
- non-trading	86	39	87	57

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

**VALUE AT RISK FOR 2008**



**VALUE AT RISK FOR 2007**





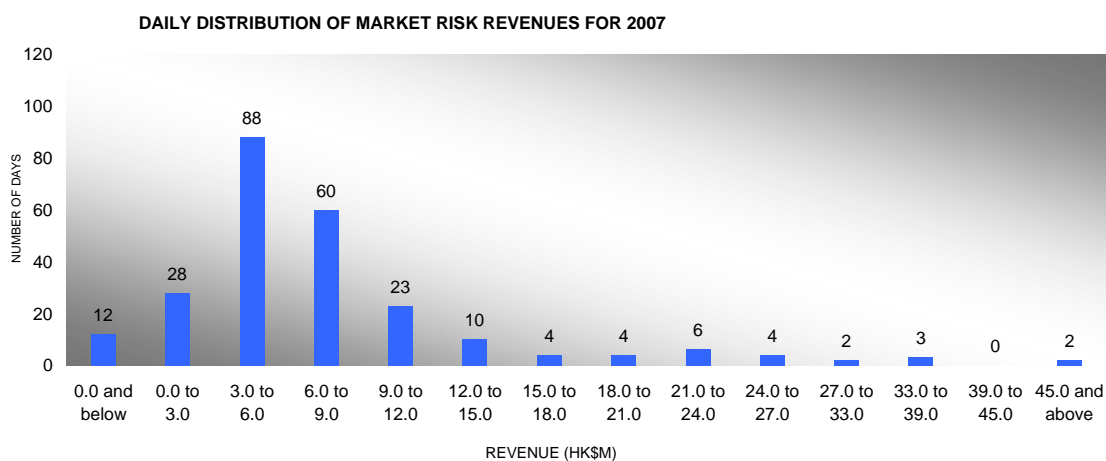
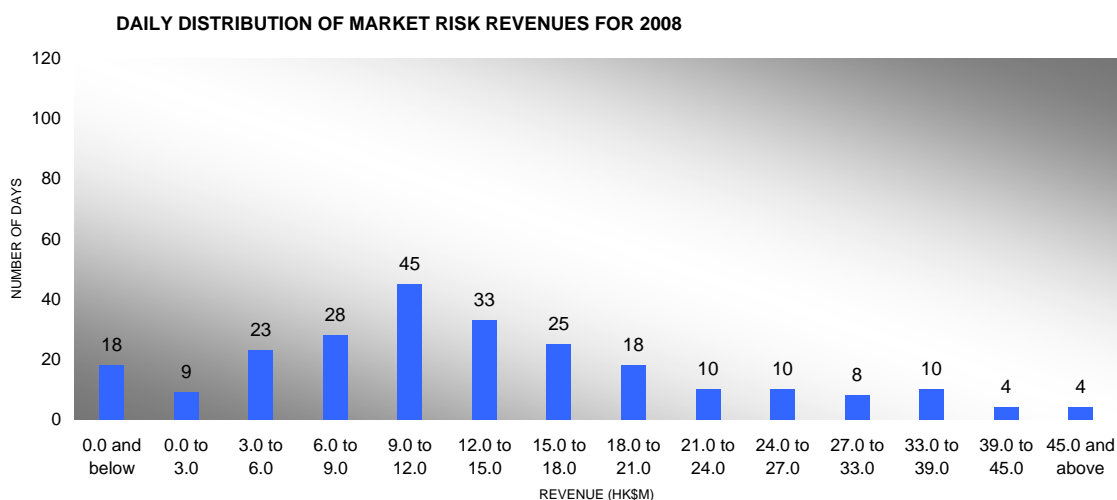
## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (c) Market risk (continued)

The average daily revenue earned from market risk-related treasury activities in 2008, including non-trading book net interest income and funding related to trading positions, was HK\$14 million (2007: HK\$8 million). The standard deviation of these daily revenues was HK\$11 million, compared with HK\$8 million for 2007.

An analysis of the frequency distribution of daily revenue shows that out of 245 trading days in 2008, losses were recorded on 18 days (2007: 12 days) and the maximum daily loss was HK\$25 million (2007: HK\$13 million). The most frequent result was a daily revenue of between HK\$3 million and HK\$15 million, with 129 occurrences (2007: 181 occurrences). The highest daily revenue was HK\$52 million (2007: HK\$63 million).



## NOTES TO THE FINANCIAL STATEMENTS (continued)

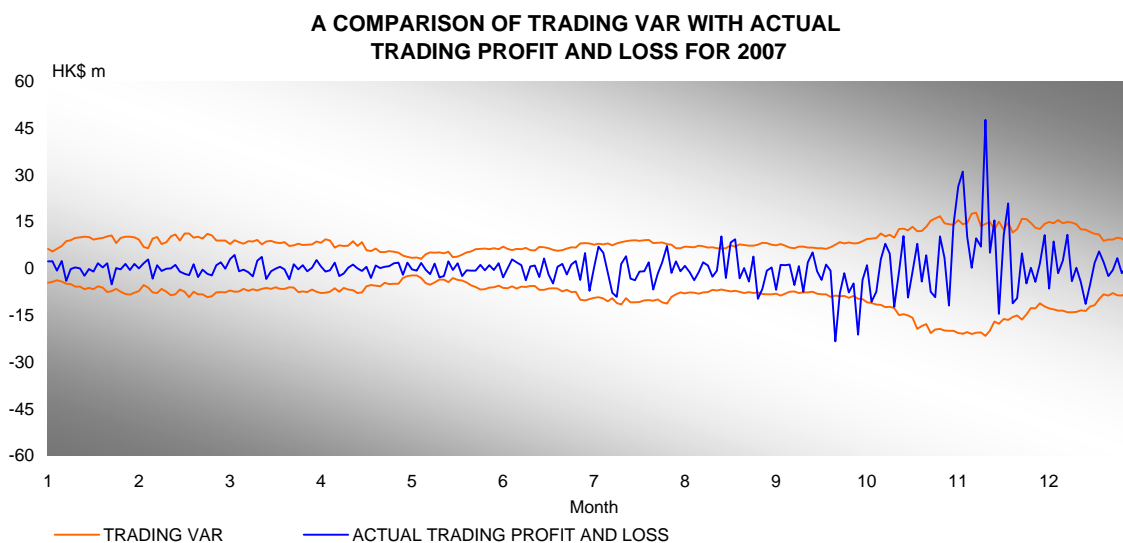
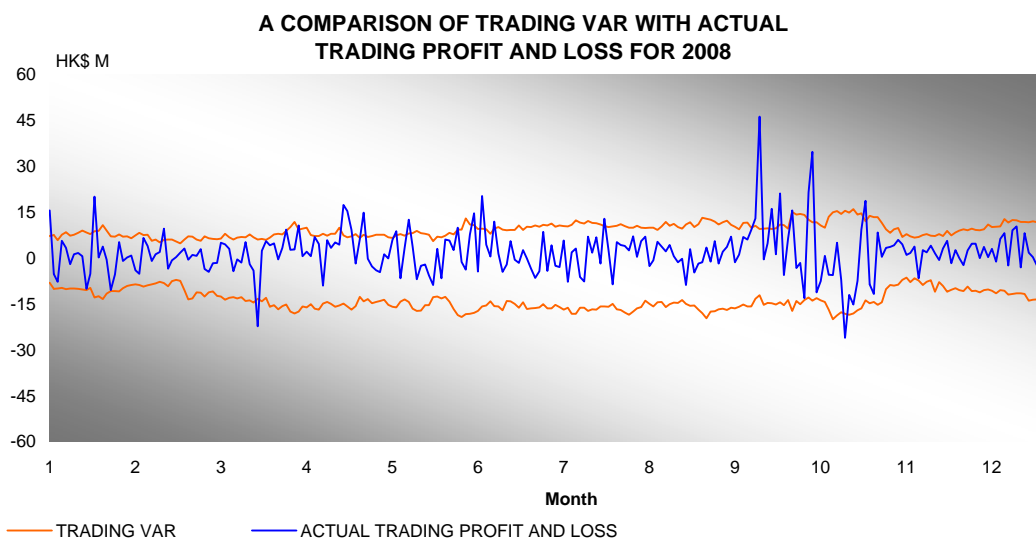
### 62 Financial Risk Management (continued)

#### (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 2008 and 2007 are shown in the table below. The exceptions of the back-testing mainly resulting 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 ALCO.

##### Trading

The Group's control of market risk is based on restricting individual operations to trading within VAR and present value of a basis point ("PVBP") 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 arising 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 Board.

##### 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 2009 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 2009.

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 2009 by HK\$533 million for 100 basis points case and by HK\$170 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\$1,181 million for 100 basis points case and by HK\$668 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 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>
<b>Change in 2008 projected net interest income</b>				
- HKD	84	78	(12)	99
- USD	151	227	75	155
- other	153	(154)	79	(79)
Total	<u>388</u>	<u>151</u>	<u>142</u>	<u>175</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 balance sheet date indicated below and the maximum and minimum month figures during the year then ended:

	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
	At 31 December 2007	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(1,141)	(1,465)	(1,141)
As a percentage of shareholders' funds at 31 December 2007 (%)	(2.0)	(2.6)	(2.0)
- 100 basis points parallel move in all-in yield curves	1,141	1,465	1,141
As a percentage of shareholders' funds at 31 December 2007 (%)	2.0	2.6	2.0

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 Board of Directors. 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>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>
<b>2007</b>				
<b>Non-structural position</b>				
Spot assets	227,698	26,160	118,436	372,294
Spot liabilities	(184,258)	(26,149)	(101,406)	(311,813)
Forward purchases	298,806	26,549	21,023	346,378
Forward sales	(335,592)	(28,330)	(38,084)	(402,006)
Net options position	32	-	(32)	-
Net long/(short) non-structural position	<u>6,686</u>	<u>(1,770)</u>	<u>(63)</u>	<u>4,853</u>
<b>Structural position</b>	<u>286</u>	<u>10,752</u>	<u>187</u>	<u>11,225</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>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>
<b>2007</b>				
<b>Non-structural position</b>				
Spot assets	184,703	7,740	76,200	268,643
Spot liabilities	(142,145)	(6,988)	(59,167)	(208,300)
Forward purchases	293,360	23,098	21,021	337,479
Forward sales	(332,143)	(22,935)	(38,081)	(393,159)
Net options position	32	-	(32)	-
Net long/(short) non-structural position	<u>3,807</u>	<u>915</u>	<u>(59)</u>	<u>4,663</u>
<b>Structural position</b>	<u>286</u>	<u>10,752</u>	<u>187</u>	<u>11,225</u>

##### Equities exposure

The Group's equities exposures in 2008 and 2007 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.

The following table shows the composition of assets and liabilities for each major insurance product category.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

##### Balance sheet 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>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
<b>2007</b>					
Financial assets:					
- financial assets designated at fair value	203	12,375	-	74	12,652
- derivatives	-	12	-	-	12
- financial investments	-	17,694	-	1,815	19,509
- other financial assets	159	3,380	473	1,005	5,017
Total financial assets	362	33,461	473	2,894	37,190
Reinsurance assets	-	10	40	23	73
PVIF <sup>5</sup>	-	-	-	2,325	2,325
Other assets	-	235	11	44	290
Total assets	362	33,706	524	5,286	39,878
Liabilities under investment contracts designated at fair value	125	384	-	-	509
Liabilities under insurance contracts	235	32,524	408	-	33,167
Deferred tax	-	-	-	414	414
Other liabilities	-	-	-	321	321
Total liabilities	360	32,908	408	735	34,411
Shareholders' equity	-	-	-	5,467	5,467
Total liabilities and shareholders' equity	360	32,908	408	6,202	39,878

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, conflagration, epidemics, earthquakes and other natural disasters that affect the properties, physical conditions and lives of the policyholders insured by the group. To mitigate these risks, excess of loss and catastrophe reinsurance arrangements have been made by the group.

For contracts where death is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics (such as AIDS, SARS or a human form of avian flu) or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. For contracts where survival is the 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**

	2008	2007
Accident and health	120	97
Fire and other damage	183	174
Motor	29	31
Liability	52	52
Marine, aviation and transport	44	43
Other (non-life)	6	4
	<u>434</u>	<u>401</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 2008 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>2008</b>					
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>

## 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	
2007					
Financial assets designated at fair value:					
- debt securities	-	6,597	-	74	6,671
- equity securities	203	5,778	-	-	5,981
	<u>203</u>	<u>12,375</u>	<u>-</u>	<u>74</u>	<u>12,652</u>
Financial investments					
Held-to-maturity:					
- debt securities	-	17,694	-	1,302	18,996
	<u>-</u>	<u>17,694</u>	<u>-</u>	<u>1,302</u>	<u>18,996</u>
Available-for-sale:					
- debt securities	-	-	-	255	255
- equity securities	-	-	-	258	258
	<u>-</u>	<u>-</u>	<u>-</u>	<u>513</u>	<u>513</u>
Derivatives	-	12	-	-	12
Other financial assets	159	3,380	473	1,005	5,017
	<u>362</u>	<u>33,461</u>	<u>473</u>	<u>2,894</u>	<u>37,190</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 2008 (2007: 1.0%). The table also shows that approximately 91.2% of financial assets was invested in debt securities at 31 December 2008 (2007: 69.7%) with 0.8% (2007: 16.8%) 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 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 2008 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

	2008		2007	
	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	210	208	319	313
- 100 basis points shift in yield curves	(139)	(136)	(361)	(355)

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

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

	2008		2007	
	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	18	18	475	500
10 per cent decrease in equity prices	(18)	(18)	(475)	(500)

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

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

##### Foreign currency risk

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

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 62 Financial risk management (continued)

#### (d) Insurance risk (continued)

##### Credit risk

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

##### 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>2008</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	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)

	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub- standard				
2007							
<b>Supporting liabilities under non-linked insurance and investment contracts</b>							
Financial assets designated at fair value							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	6,407	190	-	-	-	-	6,597
	<u>6,407</u>	<u>190</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>6,597</u>
Financial investments							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	17,165	529	-	-	-	-	17,694
	<u>17,165</u>	<u>529</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>17,694</u>
<b>Supporting shareholders funds</b>							
Financial assets designated at fair value							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	74	-	-	-	-	-	74
	<u>74</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>74</u>
Financial investments							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	1,462	95	-	-	-	-	1,557
	<u>1,462</u>	<u>95</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,557</u>
<b>Total</b>							
Financial assets designated at fair value							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	6,481	190	-	-	-	-	6,671
	<u>6,481</u>	<u>190</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>6,671</u>
Financial investments							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	18,627	624	-	-	-	-	19,251
	<u>18,627</u>	<u>624</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>19,251</u>

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:



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

**62 Financial risk management** *(continued)*

**(d) Insurance risk** *(continued)*

**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>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>
<b>2007</b>							
Linked insurance contracts	-	-	-	-	-	-	-
Non-linked insurance contracts	<u>49</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>50</u>
Total	<u>49</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>50</u>
Reinsurance Debtors	<u>14</u>	<u>2</u>	<u>-</u>	<u>7</u>	<u>-</u>	<u>-</u>	<u>23</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 2008:

##### Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				Total
	Within 1 year	1-5 years	5-15 years	Over 15 years	
<b>2008</b>					
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>
<b>2007</b>					
Non-life insurance	246	137	25	-	408
Life insurance (non-linked)	2,291	14,897	47,796	21,167	86,151
Life insurance (linked)	30	258	334	979	1,601
	<u>2,567</u>	<u>15,292</u>	<u>48,155</u>	<u>22,146</u>	<u>88,160</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>2008</b>				
Remaining contractual maturity:				
- due within 1 year	2	1	-	3
- due between 1 and 5 years	-	-	-	-
- due between 5 and 10 years	-	-	-	-
- due after 10 years	83	327	-	410
- undated	-	-	-	-
	<u>85</u>	<u>328</u>	<u>-</u>	<u>413</u>
<b>2007</b>				
Remaining contractual maturity:				
- due within 1 year	2	38	-	40
- due between 1 and 5 years	-	-	-	-
- due between 5 and 10 years	-	-	-	-
- due after 10 years	123	346	-	469
- undated	-	-	-	-
	<u>125</u>	<u>384</u>	<u>-</u>	<u>509</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 2008 was HK\$2,707 million (2007: HK\$2,324 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2008 can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

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

	2008	2007
+ 100 basis points shift in risk-free rate	504	696
– 100 basis points shift in risk-free rate	(331)	(760)
+ 100 basis points shift in risk discount rate	(153)	(104)
– 100 basis points shift in risk discount rate	172	116
+ 100 basis points shift in expenses inflation	(12)	(11)
– 100 basis points shift in expenses inflation	11	10
+ 100 basis points shift in lapse rate	793	542
– 100 basis points shift in lapse rate	(771)	(573)

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 2008 is as follows:

	Impact on 2008 results		Impact on 2007 results	
	Profit for the year	Net assets	Profit for the year	Net assets
20 per cent increase in claims costs	(26)	(26)	(24)	(24)
20 per cent decrease in claims costs	26	26	24	24
10 per cent increase in mortality and/or morbidity rates	(25)	(25)	(34)	(34)
10 per cent decrease in mortality and/or morbidity rates	26	26	34	34
50 per cent increase in lapse rates	505	505	396	396
50 per cent decrease in lapse rates	(516)	(516)	(413)	(413)
10 per cent increase in expense rates	(33)	(33)	(26)	(26)
10 per cent decrease in expense rates	33	33	26	26

## 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 Operating 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 balance sheet: 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 Foundation Internal Ratings-Based Approach for the majority of its business with effect from 1 January 2008, with the remainder on Standardised Approach. A rollout plan is in place to extend coverage of the IRB over the next three years, leaving a small residue of exposures on the Standardised Approach. The Group has also obtained approval from the Hong Kong Monetary Authority to adopt the Advanced Internal Ratings-based Approach to calculate the risk-weighted assets for credit risk effective 1 January 2009.

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, the CAD1 model 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 aims of making relevant disclosures in accordance with the disclosure rules.

During the year, the Group 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) Quoted market price

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

##### (ii) 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) 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 discrepancy in practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures. Finally, some inputs are not observable, but can generally be estimated from historic data or other sources.



## 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:

	Group					Total
	Quoted market price	<u>Valuation techniques</u> using observable inputs		with significant non- observable inputs	Third party total	
<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
<b>2007</b>						
<b>Assets</b>						
Trading assets	2,305	8,085	-	10,390	-	10,390
Financial assets						
designated at fair value	5,766	4,237	217	10,220	3,672	13,892
Derivative financial instruments	486	3,830	-	4,316	386	4,702
Available-for-sale financial investments	6,867	217,806	424	225,097	200	225,297
<b>Liabilities</b>						
Trading liabilities	4,553	39,040	4,558	48,151	-	48,151
Financial liabilities						
designated at fair value	-	1,491	7	1,498	-	1,498
Derivative financial instruments	120	2,790	-	2,910	1,773	4,683

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 63 Fair value of financial instruments (continued)

#### (a) Determination of fair value (continued)

	Bank				Amounts with HSBC entities	Total
	Quoted market price	Valuation techniques using observable inputs		Third party total		
			with significant non-observable inputs			
<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
<b>2007</b>						
<b>Assets</b>						
Trading assets	2,305	6,599	-	8,904	-	8,904
Financial assets						
designated at fair value	554	684	-	1,238	-	1,238
Derivative financial instruments	475	3,586	-	4,061	350	4,411
Available-for-sale financial investments	5,569	166,509	321	172,399	200	172,599
<b>Liabilities</b>						
Trading liabilities	4,553	38,039	4,558	47,150	-	47,150
Financial liabilities						
designated at fair value	-	989	-	989	-	989
Derivative financial instruments	60	2,618	-	2,678	1,753	4,431

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

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values due to parallel movement of plus or minus 10 per cent of change in fair value to reasonably possible alternative assumptions.

## NOTES TO THE FINANCIAL STATEMENTS (continued)

### 63 Fair value of financial instruments (continued)

#### (a) Determination of fair value (continued)

	Group			
	<u>Reflected in profit/(loss)</u>		<u>Reflected in equity</u>	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
<b>2008</b>				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	22	(22)	-	-
Available-for-sale financial investments	-	-	14	(14)
 2007				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	22	(22)	-	-
Available-for-sale financial investments	-	-	42	(42)
	Bank			
	<u>Reflected in profit/(loss)</u>		<u>Reflected in equity</u>	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
<b>2008</b>				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	-	-	-	-
Available-for-sale financial investments	-	-	3	(3)
 2007				
Derivatives/trading assets/trading liabilities	-	-	-	-
Financial assets/liabilities designated at fair value	-	-	-	-
Available-for-sale financial investments	-	-	32	(32)

#### 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	
	2008	2007	2008	2007
Recorded profit/(loss):				
Derivatives/trading assets/trading liabilities	24	55	24	55
Financial assets/liabilities designated at fair value	(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 balance sheet are calculated as described below.

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

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

#### (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 balance sheet date 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 balance sheet date.

#### (iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date 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 balance sheet. For all other instruments the fair value is equal to the carrying value:

	Group			
	2008		2007	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Financial Assets</b>				
Placings with and advances to banks and other financial institutions	69,579	69,635	113,029	113,029
Advances to customers	329,121	320,651	308,356	310,476
Held-to-maturity debt securities	36,205	39,315	18,997	19,526
<b>Financial Liabilities</b>				
Current, savings and other deposit accounts	562,183	562,257	546,653	546,710
Deposits from banks	11,556	11,556	19,736	19,736
Certificates of deposit and other debt securities in issue	2,772	2,838	5,685	5,621
Subordinated liabilities	9,309	7,849	9,354	8,980
<b>Bank</b>				
	2008		2007	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Financial Assets</b>				
Placings with and advances to banks and other financial institutions	38,097	38,154	86,137	86,137
Advances to customers	280,255	271,787	255,413	257,579
<b>Financial Liabilities</b>				
Current, savings and other deposit accounts	547,385	547,459	533,330	533,386
Deposits from banks	8,263	8,263	12,593	12,593
Certificates of deposit and other debt securities in issue	2,772	2,838	7,203	7,169
Subordinated liabilities	9,309	7,849	9,354	8,980

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

### **64 Comparative figures**

Certain comparative figures have been reclassified to conform with the current year's presentation. For details, please refer to note 62(c).

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### **65 Parent and ultimate holding company**

The parent 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 2 March 2009.

## **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 72 to 220, which comprise the consolidated and the Bank balance sheets as at 31 December 2008, and the consolidated income statement, the consolidated statement of recognised income and expense 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 2008 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.

Certified Public Accountants

8th Floor, Prince's Building  
10 Chater Road  
Central, Hong Kong

2 March 2009

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited)*

These notes set out on pages 222 to 242 are supplementary to and should be read in conjunction with the consolidated financial statements set out on pages 72 to 220. The consolidated financial statements and these supplementary notes taken together comply with the Banking (Disclosure) Rules ("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 Rules to be prepared on a different basis. In such cases, the 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 2008 as set out in note 4 to the financial statements.
- (c) Certain comparative figures have not been provided where the current year is the first year of disclosure and the provision of comparative figures is impracticable.

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### 2 Capital adequacy

#### (a) Capital adequacy ratios

The capital adequacy ratios as at 31 December 2008 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 of the Hong Kong Banking Ordinance which became effective on 1 January 2007.

In the year of 2007, the Group has adopted the Standardised approach ("STC") for the calculation of the credit risk capital requirement. With the approval from the HKMA to use the Foundation Internal Ratings-Based ("IRB") approach, the Group has migrated to a more sophisticated IRB approach and adopted this approach to calculate its credit risk for the non-securitisation exposures as at 31 December 2008. During the years of 2007 and 2008, the Group has adopted "Standardised Approach" for the calculation of operational risk capital requirement and the "Internal Models Approach" for the calculation of market risk capital requirement. As there are significant differences between IRB approach and STC approach, the capital adequacy ratios of the two years are not directly comparable.

During the Group's application of adopting IRB approach, the Group has also obtained approval from the HKMA under section 12(2)(a) of the Banking (Capital) Rules ("the Rules") to adopt Standardised Approach for certain exposures being exempted from the IRB approach for credit risk calculations. Details of credit risk calculated under Standardised Approach are shown under supplementary note 5.



## 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:

	2008	2007
<b>Capital base</b>		
Core capital:		
- share capital	9,559	9,559
- retained profits	24,290	29,437
- classified as regulatory reserve	(854)	(911)
- less: deduction from core capital	(557)	(283)
- less: 50 per cent of total unconsolidated investments and other deductions	(6,330)	(5,875)
- total core capital	<u>26,108</u>	<u>31,927</u>
Supplementary capital:		
- fair value gains on the revaluation of property	3,465	3,466
- fair value gains on the revaluation of available-for-sale investment and equity	649	823
- collectively assessed impairment allowances	78	636
- regulatory reserve	94	911
- surplus provision	101	-
- term subordinated debt	10,357	10,354
- less: 50 per cent of total unconsolidated investments and other deductions	(6,330)	(5,875)
- total supplementary capital	<u>8,414</u>	<u>10,315</u>
Total capital base after deductions	<u><u>34,522</u></u>	<u><u>42,242</u></u>
<b>Risk-weighted assets</b>		
- credit risk	235,576	342,798
- market risk	1,684	2,166
- operational risk	38,104	33,558
	<u><u>275,364</u></u>	<u><u>378,522</u></u>
Capital adequacy ratio	12.5%	11.2%
Core capital ratio	9.5%	8.4%

#### (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

With effect from 1 January 2008, the Group uses the foundation internal ratings-based ("IRB") approach approved by the HKMA for calculating the credit risks for the majority of its non-securitisation exposures, with the remainder of its credits risks assessed using the standardised (credit risk) approach. In 2007, the Group used 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 Banking (Capital) Rules.

	2008	2007
<b>Subject to internal ratings-based approach</b>		
Sovereign exposures	413	-
Bank exposures	4,005	-
Corporate exposures	9,477	-
Residential mortgages to individuals and property-holding shell companies	1,099	-
Qualifying revolving retail exposures	750	-
Small business retail exposure	12	-
Other retail exposures to individuals	316	-
Other exposures	915	-
Securitisation exposures	-	-
Equity exposures	-	-
<b>Total capital requirements for credit risk under internal ratings-based approach</b>	<b>16,987</b>	<b>-</b>
<b>Subject to standardised approach</b>		
<b>On-balance sheet</b>		
Sovereign exposures	-	78
Public sector entity exposures	43	394
Multilateral development bank exposures	-	-
Bank exposures	15	7,328
Securities firm exposures	-	126
Corporate exposures	397	11,090
Collective investment scheme exposures	6	188
Cash items	-	2
Regulatory retail exposures	142	1,353
Residential mortgage loans	586	3,705
Other exposures which are not past due exposures	467	1,398
Past due exposures	36	69
<b>Total capital requirements for on-balance sheet exposures</b>	<b>1,692</b>	<b>25,731</b>
<b>Off-balance sheet</b>		
Direct credit substitutes	35	291
Transaction-related contingencies	20	32
Trade-related contingencies	18	164
Forward asset purchases	5	9
Partly paid-up shares and securities	-	-
Forward deposits placed	-	-
Unconditionally cancellable commitments	-	-
Other commitments	54	864
Exchange rate contracts	22	191
Interest rate contracts	1	41
Equity contracts	12	101
OTC derivative transactions and credit derivative contracts subject to valid bilateral netting agreements	-	-
Other off-balance exposures which are not elsewhere specified	-	-
<b>Total capital requirements for off-balance sheet exposures</b>	<b>167</b>	<b>1,693</b>
<b>Total capital requirements for credit risk under standardised (credit risk) approach</b>	<b>1,859</b>	<b>27,424</b>
<b>Total capital requirements for credit risk</b>	<b>18,846</b>	<b>27,424</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 system and risk components

##### Nature of exposures within each internal-ratings based (IRB) class

The Group adopted internal-ratings based approach for the majority of its business with effect from 1 January 2008, with the remainder on standardised approach. The following exposures are subject to internal-ratings based approach:

- Corporate exposure includes 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 exposure includes exposures to sovereign governments, central monetary institutions and government entities.
- Bank exposure includes exposures to banks and regulated securities firms.
- Retail exposure includes residential mortgages, qualifying revolving retail exposures, small business retail exposures and other retail exposures.
- Other exposure mainly includes notes and coins, premises, plant and equipment and other fixed assets.

##### 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: judgemental, analytical, and hybrids of the two. The main characteristics of the Group's credit risk rating systems are set out below.

#### (i) Structure of Internal Ratings Systems

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 for risk management decisions.

For wholesale business (includes corporate, bank and sovereign exposures), obligor PD is estimated using a 10-grade scale Customer Risk Rating expanded into 22 buckets, of which 20 are non-default ratings representing varying degrees of strength of financial condition, and two are default ratings. Credit scores generated by models and/or scorecards for individual obligors are reviewed by credit approvers. The final approved Customer Risk Ratings are mapped to a PD value range of which the "mid-point" is used in the regulatory capital calculation. LGD and EAD estimations for wholesale business is subject to parameters set by the Regulator.

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 statistical techniques are used to develop credit risk models to provide PD, EAD and LGD estimates, incorporating 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 10 expected loss bands which are grouped under 4 categories, enabling 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)*

#### (ii) Use of internal ratings

While internal estimates derived from applying the internal-ratings based ("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 credit officers in the Group's credit risk function using a risk-based approach, tiered relative to obligor customer risk rating;
- credit monitoring: migration of obligor customer risk rating becomes an important indicator in credit monitoring process;
- pricing: customer relationship managers apply a Risk Adjusted Return on Capital methodology in risk-weighted asset ("RWA") and profitability calculators; and
- portfolio management: regular reports to senior management on analyses of exposures employing internal-ratings based (IRB) metrics.

#### (iii) Credit risk mitigation

Mitigation of credit risk is an important aspect of its effective management and takes in many forms.

In terms of internal-ratings based ("IRB") parameters, 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 probability of default ("PD") estimation, and second, those which affect estimated recoverability of obligations and require adjustment of loss given default ("LGD") / exposure at default ("EAD"). The first includes, for example, full parental or third party guarantees; the second, collateral security of various kinds such as cash, equity and mortgages over residential property, etc.

For wholesale exposures, loss given default ("LGD") values are determined by reference to parameters approved by the Regulators based on the nature of the collateral. 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 approach.

The main types of recognised collateral taken by the Group are those as stated in section 80 of the Banking (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 and residential 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 under retail business, valuations must be updated at a minimum of once every three years for residential real estate portfolio exceeding USD500m through the consistent use of reputable local house or real estate price indices and/or in-house estimates. Where the market is subject to significant changes in conditions, revaluation should be more frequent. For accounts of more than 90 days past due, an updated valuation on the mortgaged property is required upon downgrading. An updated valuation must be obtained on an annual basis or earlier if there is reason to believe that the value of the property has declined.

The Group's policy provides that netting is only to be applied where it has the legal right to do so. Under the Banking (Capital) Rules, recognised netting is defined as any netting done pursuant to a valid bilateral netting arrangement. Consistent with the Banking (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 Banking (Capital) Rules.

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)*

### 4 Credit risk under the internal-ratings based approach *(continued)*

#### (iv) 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. The Chief Credit Officer is responsible for the design and management of the Group's credit function, including approval and oversight of the risk rating systems. Regular reportings on model performance are also 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

For wholesale exposures, the assignment of customer risk rating is an independent exercise, taking into account all aspects of the borrower's risk profile. Lending executive assigns customer risk rating based on a suite of approved risk rating systems. Customer risk ratings are to be re-assessed each time that a credit proposal is formally reviewed, but at a minimum annually. Policy requirements dictate a continuous monitoring of wholesale credits by the assigned executive, formal review and reporting is required upon any material deterioration in risk profile. In the event that credit information external to the risk rating system is deemed to have a material impact on probability of default (PD), an override is permissible. Justification of the override is required to document for approval and for model validation purpose.

For retail exposures, exposures are segmented into pools in risk rating assessment. A group of sufficiently homogeneous exposures, which bears the same risk characteristics, is classified as a pool. Each exposure is assigned to a particular pool based on risk drivers of borrower risk, transaction risk and delinquency status.

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

### 4 Credit risk under the internal-ratings based approach *(continued)*

#### (b) Internal Rating Process *(continued)*

##### Probability of Default ("PD")

Probability of default ("PD") is the likelihood, expressed as a percentage, of a default event in a one-year time horizon.

For corporate exposures, probability of default ("PD") is estimated 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.

For bank exposures, probability of default ("PD") estimation 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.

For sovereign exposures, the models used to estimate probability of default ("PD") incorporate inputs comprising 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 probability of default (PD) are derived and applied to exposures denominated in the respective currencies.

For retail exposures, probability of default ("PD") estimation takes variables of facility utilisation, payment history, account conduct as well as in-house developed scorecards and credit bureau data.

##### Exposure-at-Default ("EAD")

Exposure at default (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, which include the expected additional drawdown on an available unutilised limit.

For corporate, bank and sovereign exposures, the Group applies the supervisory credit conversion factor estimation provided by the Hong Kong Monetary Authority.

For retail revolving exposures, predictive models are built to estimate additional customer drawdown for the estimation of exposure at default ("EAD"). For retail non-revolving exposures, estimation was based on the sum of current principal outstanding.

##### Loss given default ("LGD")

Loss given default ("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 exposure at default ("EAD").

For corporate, bank and sovereign exposures, the Group applies the supervisory loss given default factor estimation provided by the Hong Kong Monetary Authority.

For retail exposures, loss given default (LGD) model is built based on the Group's internal loss and default experience where the estimation of loss given default (LGD) reflects economic downturn conditions.

## 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 Banking (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% of the Group's risk weighted amount for credit risk calculated using IRB Approach.

#### (d) Exposures subject to supervisory estimates

The Group received approval from HKMA to use the Basel II Foundation Internal Based Approach ("FIRB") for credit risk for its Corporate, Sovereign and Bank portfolios. Approvals for the FIRB approach enables the Group to rely on its own internal estimates for some of the necessary credit risk components in determining the capital requirement for a given credit exposure. Internal estimate is used for PD, while for LGD and Maturity, the HKMA provided estimates are used. PDs and LGDs are the key inputs for EL estimates.

The following table indicates the exposure classes and the respective exposure amounts that are subject to supervisory estimates as at 31 December 2008:

	<b>2008</b>
<b>IRB Exposure Class</b>	
Sovereign exposures	50,696
Bank exposures	179,639
Corporate exposures	188,446
Other exposures	14,629
<b>Total EAD</b>	<b><u>433,410</u></b>

**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 following shows the Group's exposures:

	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>

**(f) Exposures by credit risk mitigation used**

The table below shows the total exposure amount by IRB portfolio other than OTC derivatives which is covered by recognised collaterals or guarantees as at 31 December 2008.

Portfolio	Exposures covered by collaterals	Exposures covered by guarantees
Bank exposures	32	31,511
Corporate exposures	30,993	49,161
Retail exposures		
- Residential mortgages to individuals and property-holding shell companies	97,449	17,522
- Small business retail exposures	3,119	-
- Other retail exposures to individuals	6,416	-
	<u>138,009</u>	<u>98,194</u>

For classes of sovereign exposure, qualifying revolving retail exposure and other exposure, there were no exposures covered by collaterals or guarantees



## 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

The tables below details the total exposure at default (EAD) of sovereign, bank and corporate exposures by exposure-weighted average risk-weight and exposure-weighted average probability of default (PD) for each obligor grades as at 31 December 2008.

The exposure of default disclosed below in respect of corporate, sovereign and bank exposures have taken into account the effect of recognised collateral and recognised guarantees.

#### (i) Sovereign exposure

Obligor Grade	Exposure-weighted average PD %	Exposure-weighted average risk-weight %	Exposure at default
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>

#### (ii) Bank exposure

Obligor Grade	Exposure-weighted average PD %	Exposure-weighted average risk-weight %	Exposure at default
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>

**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) Corporate exposure

<b>Obligor Grade</b>	<b>Exposure-weighted average PD %</b>	<b>Exposure-weighted average risk-weight %</b>	<b>Exposure at default</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>

(iv) Specialised lending

The specialised lending portfolio subject to supervisory slotting is classified under corporate and is measured utilising the internal ratings-based approach. Supervisory risk-weights have been specified by HKMA in determining credit exposure for this portfolio.

<b>Obligor Grade</b>	<b>Weighted average risk-weight %</b>	<b>Exposure at default</b>
Strong	65.42	11,225
Good	93.46	2,997
Satisfactory	121.90	527
Weak	265.00	285
		<u>15,034</u>

(v) Retail exposure

The following shows a breakdown of exposures (the EAD of on-balance sheet exposures and off-balance sheet exposures) on a pool basis into expected loss bands:

<b>Expected Loss bands</b>	<b>Residential Mortgages</b>	<b>Qualifying revolving retail exposures</b>	<b>Small business retail exposures</b>	<b>Other retail exposures</b>	<b>Total exposures</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>

## 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 following sets out the actual losses (including write-offs and impairment loss allowances) for the year and the expected loss as at 31 December 2007.

Exposure Class	2008	2007
Sovereign	-	-
Bank	1,375	-
Corporate	1,109	350
Residential mortgage	(20)	22
Qualifying revolving retail	312	223
Other retail	73	69
	<u>2,849</u>	<u>664</u>

Exposure Class	Expected loss at 31 December 2007
Sovereign	3
Bank	551
Corporate	811
Residential mortgage	251
Qualifying revolving retail	282
Other retail	399
	<u>2,297</u>

The following sets out the percentage of the actual number of defaults at 31 December 2008 compared against the estimated probability of default at 31 December 2007 of the respective portfolio.

Exposure Class	Actual default rate for 2008	Estimated probability of default at 31 December 2007
Sovereign	0.00%	0.06%
Bank	0.63%	0.28%
Corporate	2.24%	3.09%
Residential mortgage	0.31%	1.05%
Qualifying revolving retail	0.54%	0.62%
Other retail	2.32%	5.38%

The actual default rate is measured by using the number of obligor defaulted for the annual reporting period whereas the estimated probability of default is the long run average default rate estimated for 2008.

As the Group only reported on IRB approach commencing from 1 January 2008, the information on actual loss and default rate is for reference only as they may not have covered a period sufficient enough to enable assessment on the performance of internal rating models.

## 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 external credit assessment institutions ("ECAIs") to calculate its capital adequacy requirements under the standardised (credit risk) approach prescribed in the Banking (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 Banking (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 Banking (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**

**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>								
Off-balance sheet exposures other than OTC derivative transactions or credit 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>		
<b>Total</b>	<u>44,616</u>	<u>10,861</u>	<u>27,145</u>	<u>1,796</u>	<u>21,446</u>	<u>23,242</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)**

2007

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			
On-balance sheet								
Sovereign	15,418	17,123	-	969	-	969	-	-
Public sector entity	6,222	24,636	-	4,927	-	4,927	-	552
Multilateral development bank	5,702	5,702	-	-	-	-	-	-
Bank	308,470	309,506	1,051	91,071	526	91,597	-	719
Securities firm	3,215	91	3,064	46	1,532	1,578	60	-
Corporate	158,990	12,027	134,150	4,472	134,150	138,622	9,573	8,698
Collective investment scheme	2,354	-	2,354	-	2,354	2,354	-	-
Cash items	6,804	-	6,804	-	30	30	-	-
Regulatory retail Residential mortgage loan	22,823	-	22,544	-	16,908	16,908	279	-
Other exposures which are not past due exposures	128,762	-	109,735	-	46,307	46,307	61	18,966
Past due exposures	17,964	621	16,856	621	16,856	17,477	486	-
	768	-	768	-	862	862	171	137
	<u>677,492</u>	<u>369,706</u>	<u>297,326</u>	<u>102,106</u>	<u>219,525</u>	<u>321,631</u>	<u>10,630</u>	<u>29,072</u>
Off-balance sheet								
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	19,264	2,622	16,642	1,292	15,707	16,999	636	73
OTC derivative contracts	12,824	11,258	1,566	2,718	1,450	4,168	-	-
Credit derivative contracts	-	-	-	-	-	-	-	-
Other off-balance sheet exposures not elsewhere specified	-	-	-	-	-	-	-	-
	<u>32,088</u>	<u>13,880</u>	<u>18,208</u>	<u>4,010</u>	<u>17,157</u>	<u>21,167</u>		
Total	<u>709,580</u>	<u>383,586</u>	<u>315,534</u>	<u>106,116</u>	<u>236,682</u>	<u>342,798</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)

### 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 standardised/internal ratings-based 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

	<b>OTC derivative transactions</b>
<b>2008</b>	
OTC derivative transactions:	
Gross total positive fair value which are not repo-style transactions	<b>6,578</b>
Credit equivalent amount	<b>14,486</b>
Value of recognised collateral by type:	
Debt securities	-
Others	-
	<u>-</u>
Credit equivalent amount or net credit exposures net of recognised collateral held	<u><b>14,486</b></u>
Risk-weighted amount	<u><b>4,110</b></u>
Notional amount of recognised credit derivative contracts which provide credit protection	<u>-</u>
<b>2007</b>	
OTC derivative transactions:	
Gross total positive fair value which are not repo-style transactions	4,168
Credit equivalent amount	12,824
Value of recognised collateral by type:	
Debt securities	-
Others	-
	<u>-</u>
Credit equivalent amount or net credit exposures net of recognised collateral held	<u><b>12,824</b></u>
Risk-weighted amount	<u><b>4,168</b></u>
Notional amount of recognised credit derivative contracts which provide credit protection	<u>-</u>

There was no outstanding repo-style transactions and credit derivative contracts at 31 December 2008 (2007: Nil).

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

### 6 Counterparty credit risk-related exposures *(continued)*

#### (c) Major classes of exposures by counterparty type

	2008			2007		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
Sovereign	1,766	18	4	-	-	-
Public sector entities	1,436	15	3	987	8	2
Banks	763,517	12,753	3,082	791,396	11,251	2,718
Corporates	49,278	1,700	1,021	31,187	1,565	1,448
	<u>815,997</u>	<u>14,486</u>	<u>4,110</u>	<u>823,570</u>	<u>12,824</u>	<u>4,168</u>

### 7 Asset securitisation

There was no asset securitisation for which the Group is an originating institution or an investing institution at 31 December 2008.

### 8 Market risk

The Hong Kong Monetary Authority has granted approval under section 18(2)(a) and 18(5) of the Banking (Capital) Rules for the Group to use the Internal Models Approach ("IMM") 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.

	2008	2007
Market risk calculated by:		
- Internal Models Approach:		
-- Foreign exchange exposures and general interest rate exposures	114	141
- Standardised Approach:		
-- Specific interest rate exposures	20	32
-- Equity exposures	1	-
-- Commodity exposures	-	-
Total capital charge for market risk	<u>135</u>	<u>173</u>

### 9 Operational risk capital charge

The Hong Kong Monetary Authority has granted approval under section 25(2) of the Banking (Capital) Rules for the Group to use the Standardised Approach to calculate its operational risk.

	2008	2007
Capital charge for operational risk	<u>3,048</u>	<u>2,685</u>



## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 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.

	2008	2007
Cumulative realised gains on disposal	255	442
Unrealised gains:		
- recognised in reserve but not through the income statement	254	1,552
- deducted from the supplementary capital	-	-

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### 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 2008</b>	<b><u>63</u></b>	<b><u>66</u></b>
At 31 December 2007	<u>1,001</u>	<u>998</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**

Impaired advances, overdue advances, individually assessed and collectively assessed loan impairment allowances, the amount of new impairment allowances charged to income statement, and the amount of impaired loans and advances written off during the year in respect of industry sectors which constitute not less than 10 per cent of gross advances to customers are analysed as follows:

	<b>Group</b>					<b>Advances written off during the year</b>
	<b>Gross advances</b>	<b>Impaired advances</b>	<b>Individually assessed loan impairment allowances</b>	<b>Collectively assessed loan impairment allowances</b>	<b>New impairment allowances</b>	
<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
<b>2007</b>						
Residential mortgages	100,725	474	(31)	(95)	19	15
Commercial, industrial and international trade	58,967	594	(361)	(316)	367	196
Commercial real estate	32,861	22	-	(5)	-	-
Other property-related lending	45,058	21	(8)	(43)	5	23

**SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)**

**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>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>
Mainland exposures of HACN	<u>26,537</u>	<u>7,900</u>	<u>34,437</u>	<u>290</u>
	<u><u>43,973</u></u>	<u><u>13,928</u></u>	<u><u>57,901</u></u>	<u><u>460</u></u>
	On-balance sheet exposure	Off-balance sheet exposure	Total exposures	Individually assessed allowances
<b>2007</b>				
Mainland entities	7,246	6,111	13,357	1
Companies and individuals outside Mainland where the credit is granted for use in Mainland	6,397	5,376	11,773	88
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	50	278	328	-
	<u>13,693</u>	<u>11,765</u>	<u>25,458</u>	<u>89</u>
Mainland exposures of HACN	<u>25,582</u>	<u>9,966</u>	<u>35,548</u>	<u>125</u>
	<u><u>39,275</u></u>	<u><u>21,731</u></u>	<u><u>61,006</u></u>	<u><u>214</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>2008</b>				
Asia-Pacific excluding Hong Kong:				
- Australia	21,088	-	431	21,519
- China	13,539	-	11,202	24,741
- Japan	8,933	-	74,127	83,060
- Other	16,212	-	6,054	22,266
	59,772	-	91,814	151,586
The Americas:				
- United States	34,673	25	34,206	68,904
- Canada	10,784	-	6,963	17,747
- Other	16	-	3,842	3,858
	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
<b>2007</b>				
Asia-Pacific excluding Hong Kong:				
- Australia	33,865	-	397	34,262
- China	20,668	-	12,615	33,283
- Japan	11,802	-	149	11,951
- Other	32,308	-	6,091	38,399
	98,643	-	19,252	117,895
The Americas:				
- United States	29,111	1,187	6,866	37,164
- Canada	14,428	240	3,893	18,561
- Other	45	-	4,051	4,096
	43,584	1,427	14,810	59,821
Europe:				
- United Kingdom	33,031	-	8,511	41,542
- Other	123,002	-	4,627	127,629
	156,033	-	13,138	169,171

## ANALYSIS OF SHAREHOLDERS

As at 31 December 2008	Shareholders		Shares of HK\$5 each	
	Number	Percentage of total	Number in millions	Percentage of total
<b>Number of shares held</b>				
1 - 500	6,198	33.10	1.5	0.08
501 - 2,000	5,968	31.88	7.3	0.38
2,001 - 5,000	3,145	16.80	10.7	0.56
5,001 - 20,000	2,586	13.81	26.3	1.37
20,001 - 50,000	534	2.85	16.6	0.87
50,001 - 100,000	157	0.84	11.4	0.60
100,001 - 200,000	73	0.39	10.4	0.54
Over 200,000	61	0.33	1,827.6	95.60
	<b>18,722</b>	<b>100.00</b>	<b>1,911.8</b>	<b>100.00</b>

### Geographical Distribution

Hong Kong	18,343	97.98	1,908.3	99.81
Malaysia	76	0.41	0.6	0.03
Singapore	46	0.24	2.0	0.10
Macau	32	0.17	0.1	0.01
Canada	60	0.32	0.1	0.01
United Kingdom	39	0.21	0.1	0.01
United States of America	49	0.26	0.3	0.01
Australia	45	0.24	0.1	0.01
Others	32	0.17	0.2	0.01
	<b>18,722</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

Raymond C F Or JP

### Directors

Edgar D Ancona

John C C Chan GBS, JP

Patrick K W Chan

Y T Cheng GBM, DPMS, DBA(Hon), LLD(Hon), DSSc(Hon)

Marvin K T Cheung DBA(Hon), GBS, SBS, OBE, JP

Alexander A Flockhart CBE

Jenkin Hui

Peter T C Lee JP

Eric K C Li FCPA(Practising), GBS, OBE, JP

Vincent H S Lo GBS, JP

Joseph C Y Poon

David W K Sin DSSc(Hon)

Richard Y S Tang MBA, BBS, JP

Peter T S Wong JP

### Secretary

C C Li

## Registered Office

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## Stock Code

The Stock Exchange of Hong Kong Limited: 11

## Registrars

Computershare Hong Kong Investor Services Limited

Rooms 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  
Telephone: 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 2008**

The Annual Report 2008 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 2008 by electronic means and wish to receive a printed copy; or
- B) receive this Annual Report 2008 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  
Rooms 1806-7, 18th 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 2008 by electronic means through the Bank's website and who, for any reason, have difficulty in receiving or gaining access to this Annual Report 2008, may submit a written request to the Bank's Registrars, Computershare Hong Kong Investor Services Limited, and will be sent this Annual Report 2008 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

### 2008 Full Year Results

Announcement date 2 March 2009

### 2008 Fourth Interim Dividend\*

Announcement date 2 March 2009

Book close and record date 18 March 2009

Payment date 31 March 2009

### 2008 Annual Report

to be posted to shareholders in late March 2009

### Annual General Meeting

to be held on 6 May 2009

### 2009 Half Year Results

Announcement date 3 August 2009

### 2009 Interim Report

to be posted to shareholders in late August 2009

### *Proposed dates for 2009:*

### 2009 First Interim Dividend

Announcement date 5 May 2009

Book close and record date 21 May 2009

Payment date 4 June 2009

### 2009 Second Interim Dividend

Announcement date 3 August 2009

Book close and record date 18 August 2009

Payment date 2 September 2009

### 2009 Third Interim Dividend

Announcement date 2 November 2009

Book close and record date 17 November 2009

Payment date 2 December 2009

### 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

\* *The Register of Shareholders of the Bank will be closed on Wednesday, 18 March 2009, 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, Rooms 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong, for registration not later than 4:30 pm on Tuesday, 17 March 2009. The fourth interim dividend will be payable on Tuesday, 31 March 2009 to shareholders on the Register of Shareholders of the Bank on Wednesday, 18 March 2009.*