



恒生銀行
HANG SENG BANK

Annual Report 2013

2013年年報

The printed version of Hang Seng Bank's Annual Report 2013
will replace this version in late March 2014.

恒生銀行2013年年報之印刷本將於2014年3月下旬取代此版本。

CONTENTS

Corporate Profile	1
Results in Brief *	3
Five-year Financial Summary	4
Chairman's Statement *	6
Chief Executive's Report *	8
Management Discussion and Analysis	
- Business in Hong Kong	10
- Business on the Mainland	15
- Financial Review	17
- Risk Management	32
- Capital Management	83
Corporate Responsibility	89
Corporate Governance and Other Information	94
Biographical Details of Directors	118
Biographical Details of Senior Management	130
Report of the Directors	134
2013 Financial Statements	142
Independent Auditor's Report	265
Supplementary Notes to the Financial Statements (<i>unaudited</i>)	266
Analysis of Shareholders	287
Subsidiaries	288
Corporate Information and Calendar	289

* Where possible, percentages in this section have been rounded to the nearest percentage point to facilitate easy reading. Percentage-based indicators remain at 1 or 2 decimal places as appropriate.

The abbreviations 'HK\$m' and 'HK\$bn' represent millions and billions of Hong Kong dollars respectively.

CORPORATE PROFILE

Founded in 1933, Hang Seng Bank Limited is one of Hong Kong's largest listed companies. Our market capitalisation as at 31 December 2013 was HK\$240.3bn.

With nearly 10,000 employees, we serve over half the adult population of Hong Kong – more than 3 million people – through about 220 service outlets. We also maintain branches in Macau and Singapore and a representative office in Taipei.

Established in 2007 and headquartered in Shanghai, our wholly owned mainland China subsidiary Hang Seng Bank (China) Limited operates a network of 50 outlets in Beijing, Shanghai, Guangzhou, Shenzhen, Fuzhou, Nanjing, Dongguan, Hangzhou, Ningbo, Tianjin, Kunming, Xiamen, Chengdu, Foshan, Zhongshan, Huizhou, Zhuhai, Jiangmen and Shantou.

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

Celebrating 80 Years of Service Excellence

Since opening our doors in 1933 as a small money-changer, our unwavering dedication to serving the community has seen us grow to become Hong Kong's leading domestic bank.

"Hang Seng's success is built on the core principles established by our founders. Throughout our history, staff at all levels have upheld these values – emphasising service excellence and a prudent-yet-progressive approach in striving for sustainable growth."

Rose Lee, Vice-Chairman and Chief Executive, Hang Seng Bank

In 2013, we held a year-long series of celebratory anniversary activities under an '80 Years of Service Excellence' theme.

The series highlight was a cocktail reception – held at the Hong Kong Convention and Exhibition Centre and officiated by Financial Secretary John Tsang – attended by more than 2,000 people from across the community.

To further share our success with those who help to create it, we also engaged in several special anniversary initiatives through our wide-ranging corporate responsibility programme, including committing to help construct 800 more biogas facilities under the Hang Seng Yunnan Biogas Project and holding a family fun day for staff.

As we invest in the future as the 'ever-growing' bank, we remain true to our heritage and passionate about our commitment to serve.

RATINGS

MOODY'S		
Hang Seng Bank	Long-term Bank Deposit (local and foreign currency)	Aa2
	Short-term Bank Deposit (local and foreign currency)	Prime-1
	Bank Financial Strength	B
	Outlook	Stable
Hang Seng China	Long-term Bank Deposit (local and foreign currency)	A3
	Short-term Bank Deposit (local and foreign currency)	Prime-2
	Bank Financial Strength	D-
	Outlook	Stable

STANDARD & POOR'S		
Hang Seng Bank	Long-term Counterparty Credit (local and foreign currency)	AA-
	Short-term Counterparty Credit (local and foreign currency)	A-1+
	Outlook	Stable
Hang Seng China	Long-term Counterparty Credit (local and foreign currency)	AA-
	Short-term Counterparty Credit (local and foreign currency)	A-1+
	Outlook	Stable

RESULTS IN BRIEF

	2013	2012 (restated)
For the year	HK\$m	HK\$m
Operating profit excluding loan impairment charges	18,946	15,873
Operating profit	18,410	15,487
Profit before tax ¹	28,496	21,994
Profit attributable to shareholders ¹	26,678	19,327
	%	%
Return on average shareholders' funds ¹	25.4	22.8
Cost efficiency ratio	32.4	34.9
Average liquidity ratio	34.9	36.9
	HK\$	HK\$
Earnings per share ¹	13.95	10.11
Dividends per share	5.50	5.30
At year-end	At 31 December 2013	At 31 December 2012
	HK\$m	HK\$m
Shareholders' funds	107,778	92,323
Total assets	1,143,730	1,077,096
	%	%
Capital ratios under Basel III ²		
- Common Equity Tier 1 ("CET1") Capital Ratio	13.8	-
- Tier 1 Capital Ratio	13.8	-
- Total Capital Ratio	15.8	-
Capital ratios under Basel II ²		
- Core capital ratio	-	12.2
- Capital adequacy ratio	-	14.0

¹ **Industrial Bank Co., Ltd. ("Industrial Bank") reclassification**

Reported results for 2013 include a non-distributable accounting gain on the reclassification of Industrial Bank from an associate to a financial investment of HK\$8,454m before tax (HK\$9,517m attributable profit). Reported results for 2012, when the investment in Industrial Bank was equity accounted for, include share of profit from Industrial Bank of HK\$5,199m before tax (HK\$4,855m attributable profit). Figures quoted as "excluding the Industrial Bank reclassification" have been adjusted for the above items. Excluding the Industrial Bank reclassification, key financial results and performance metrics are set out below for comparison purpose:

	2013	2012
Profit before tax (HK\$m)	20,042	16,795
Profit attributable to shareholders (HK\$m)	17,161	14,472
Earnings per share (HK\$)	8.98	7.57
Return on average shareholders' funds (%)	17.6	17.1

² On 1 January 2013, the Hong Kong Monetary Authority ("HKMA") implemented the first phase of the Basel III capital framework in Hong Kong. The capital disclosures for 2013 under Basel III are, therefore, not directly comparable with the disclosure for 2012 prepared under Basel II basis.

Comparative figures have been restated to reflect the adoption of the Hong Kong Accounting Standard 19 "Employee Benefits", details of which are set out in note 1 to the financial statements.

FIVE-YEAR FINANCIAL SUMMARY

	2009 (restated)	2010 (restated)	2011 (restated)	2012 (restated)	2013
For the year	HK\$bn	HK\$bn	HK\$bn	HK\$bn	HK\$bn
Operating profit	13.0	14.0	14.1	15.5	18.4
Profit before tax ¹	15.2	17.2	19.2	22.0	28.5
Profit attributable to shareholders ¹	13.0	14.9	16.8	19.3	26.7
At year-end	HK\$bn	HK\$bn	HK\$bn	HK\$bn	HK\$bn
Shareholders' funds	62.7	70.7	79.6	92.3	107.8
Issued and paid up capital	9.6	9.6	9.6	9.6	9.6
Total assets	830.8	917.1	975.7	1,077.1	1,143.7
Total liabilities	768.1	846.4	896.1	984.8	1,035.9
Per share	HK\$	HK\$	HK\$	HK\$	HK\$
Earnings per share ¹	6.82	7.80	8.80	10.11	13.95
Dividends per share	5.20	5.20	5.20	5.30	5.50
Ratios	%	%	%	%	%
Return on average shareholders' funds ¹	22.5	22.6	22.6	22.8	25.4
Post-tax return on average total assets	1.6	1.7	1.8	1.9	2.4
Capital ratios under Basel III ²					
- Common Equity Tier 1 ("CET1") Capital Ratio	-	-	-	-	13.8
- Tier 1 Capital Ratio	-	-	-	-	13.8
- Total Capital Ratio	-	-	-	-	15.8
Capital ratios under Basel II ²					
- Core capital ratio	12.8	10.8	11.6	12.2	-
- Capital adequacy ratio	15.8	13.6	14.3	14.0	-
Cost efficiency ratio	33.4	34.2	35.3	34.9	32.4

¹ Industrial Bank Co., Ltd. ("Industrial Bank") reclassification

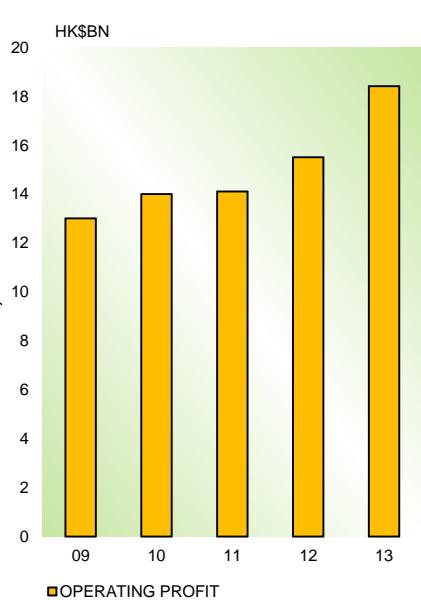
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	2013	2012
Profit before tax (HK\$bn)	20.0	16.8
Profit attributable to shareholders (HK\$bn)	17.2	14.5
Earnings per share (HK\$)	8.98	7.57
Return on average shareholders' funds (%)	17.6	17.1

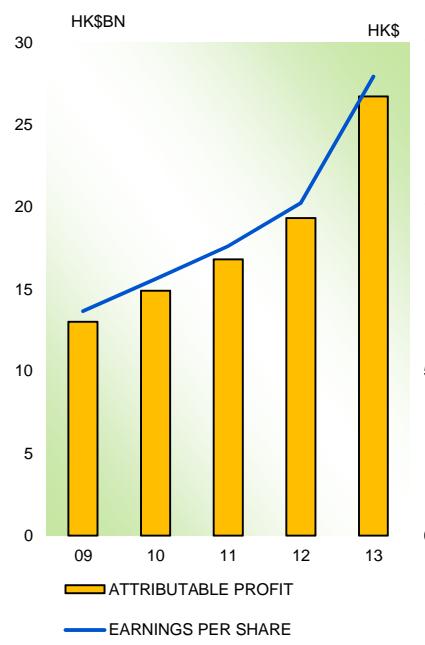
² On 1 January 2013, the Hong Kong Monetary Authority ("HKMA") implemented the first phase of the Basel III capital framework in Hong Kong. The capital disclosures for 2013 under Basel III are, therefore, not directly comparable with the disclosure for 2012 prepared under Basel II basis.

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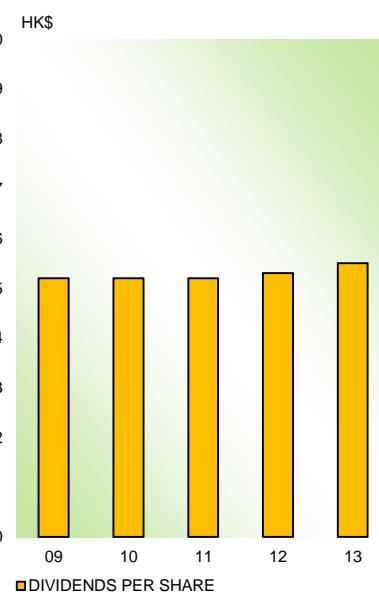
RESULTS



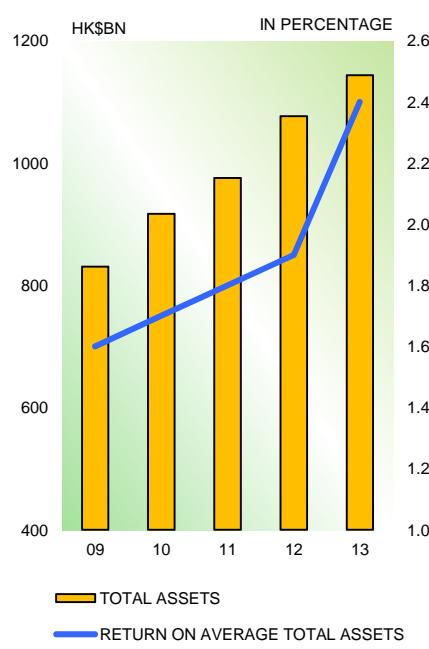
ATTRIBUTABLE PROFIT AND EARNINGS PER SHARE



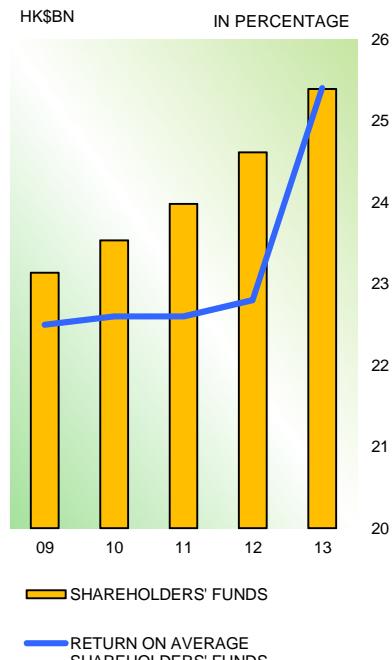
DIVIDENDS PER SHARE



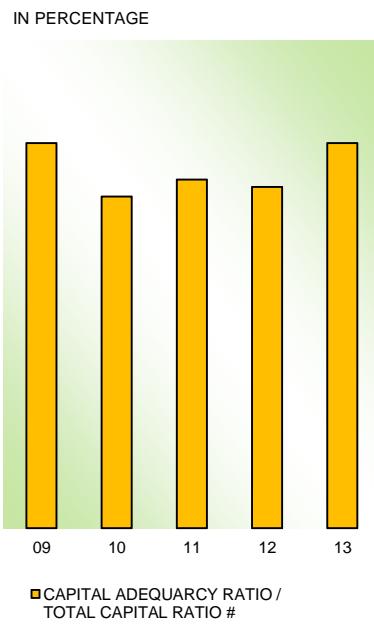
TOTAL ASSETS AND RETURN ON AVERAGE TOTAL ASSETS



SHAREHOLDERS' FUNDS AND RETURN ON AVERAGE SHAREHOLDERS' FUNDS



CAPITAL ADEQUACY RATIO / TOTAL CAPITAL RATIO



On 1 January 2013, the Hong Kong Monetary Authority ("HKMA") implemented the first phase of the Basel III capital framework in Hong Kong. The capital disclosures for 2013 under Basel III are, therefore, not directly comparable with the disclosure for 2012 prepared under Basel II basis.

CHAIRMAN'S STATEMENT

Hang Seng Bank returned solid results for 2013. We capitalised on early signs of a return to greater stability in the global economy by continuing to emphasise service excellence while further leveraging our competitive strengths.

Building on the strong platform provided by our extensive cross-border network, trusted brand and market insight, we enhanced operational efficiency, service convenience and product choice for customers.

Profit attributable to shareholders was HK\$26,678m – an increase of 38% compared with 2012. Earnings per share also rose by 38% to HK\$13.95. Excluding the Industrial Bank reclassification, profit attributable to shareholders and earnings per share both increased by 19% to HK\$17,161m and HK\$8.98 respectively.

Return on average shareholders' funds was 25.4%, compared with 22.8% in 2012. Excluding the Industrial Bank reclassification, return on average shareholders' funds was 17.6%, compared with 17.1% a year earlier.

The Directors have declared a fourth interim dividend of HK\$2.20 per share. This brings the total distribution for 2013 to HK\$5.50 per share – up from HK\$5.30 in 2012. We remain committed to a dividend policy that reflects a good balance between annual distributions and investment for future growth.

Economic Environment

The global economic environment improved in 2013. The US economy expanded at a moderate pace, supported by indications of a recovery in the housing market. Conditions in the eurozone stabilised, with the region returning to economic growth in the second quarter following an 18-month recession.

Favourable labour market conditions in Hong Kong underpinned consumer spending, supporting steady GDP growth of 3% for the first three quarters of the year. Trade activity, however, remained weak with the improvement in the global economy yet to be reflected in export demand. Private consumption remains the key economic driver and we expect 2013 full-year growth of 3%.

Mainland China's economy grew by 7.7% in 2013 – the same as in 2012 and above the official target of 7.5%. The government's selective stimulation policies supported domestic consumption and investment, with real GDP expanding by 7.8% in the second half of the year – up from 7.6% in the first half. Economic challenges will persist, but domestic drivers should remain resilient and we expect real GDP growth of 7.6% for 2014.

Asia will generally benefit from the recovery in the international economy, although the reduction of quantitative easing measures in the US will continue to create some challenges and uncertainty in the region. Closer economic integration in the Greater China region and Hong Kong's position as a primary centre for offshore renminbi financial services will open up new avenues for business.

It was with great sadness that we marked the passing away of Dr the Hon Lee Quo-Wei, Honorary Senior Advisor to Hang Seng, in August last year. Dr Lee served the Bank with distinction for more than 60 years, rising to the position of Executive Chairman in 1983 and appointed Non-executive Chairman upon his retirement in 1996. He was a key figure in promoting core values such as service excellence, business integrity and good corporate citizenship that remain central to our business strategy and brand strength.

Mrs Dorothy Sit stepped down as Executive Director and Head of China Business of Hang Seng upon retiring from the Bank on 1 January this year. On behalf of the Board, I wish to offer Mrs Sit sincere thanks for her many contributions to Hang Seng – particularly her work for the long-term development of Hang Seng Bank (China) Limited and Mainland business. Mr Gordon Lam, formerly Deputy Chief Executive of Hang Seng China, has taken up the position of Vice-Chairman and Chief Executive of Hang Seng China.

I also wish to express the Board's gratitude to Mr Jenkin Hui, who stepped down from his position as an independent Non-executive Director of Hang Seng in May 2013, and to Ms Anita Fung, who stepped down as a Non-executive Director in January this year. We thank Mr Hui and Ms Fung for their wise counsel and guidance during their tenures as members of the Hang Seng Board.

I am pleased to announce that Mr Nixon Chan, Head of Retail Banking and Wealth Management of Hang Seng, has been appointed as an Executive Director of the Bank with effect from 31 January 2014.

We marked our 80th anniversary in 2013 with a year-long series of celebratory activities under an '80 Years of Service Excellence' theme that reflects our unwavering commitment to the key principles – including excellence, integrity and innovation – established by the Bank's founders. I would like to express my appreciation to all staff for their continuing hard work to grow our business while upholding our core values. I also wish to thank our customers for their loyalty and trust and our shareholders for supporting our vision for sustainable growth.

We will take full advantage of new opportunities and maintain our strong position in our core business by continuing with our strategic plan for sustainable growth.

Raymond Ch'ien

Chairman

Hong Kong, 24 February 2014

CHIEF EXECUTIVE'S REPORT

Hang Seng Bank made good progress with its customer-driven strategy to achieve solid results in 2013.

Profit attributable to shareholders increased by 38% compared with 2012 to HK\$26,678m and return on average shareholders' funds was up 2.6 percentage points at 25.4%. Excluding the Industrial Bank reclassification, attributable profit rose by 19% and return on average shareholders' funds was 17.6%.

International economic conditions improved, but market competition remained strong as banks sought to capitalise on the upturn in investor sentiment and a more positive outlook among businesses in the region.

We continued to invest in technology, service channels and our branch network to deepen existing customer relationships and acquire new clients in target segments. Along with more effective cross-selling and other revenue diversification initiatives, we achieved a 10% rise in net interest income and a 27% increase in non-funds income. Our strong product development capabilities facilitated a swift response to improvement in the investment environment, driving a 15% rise in total wealth management income.

Our extensive southern China network and deep market knowledge reinforced our position as a leading provider of cross-border and offshore renminbi-related services. In November, we became the first local financial institution in Hong Kong to launch a Renminbi Qualified Foreign Institutional Investor exchange-traded fund.

Enhancements to Hang Seng Bank (China) Limited's service delivery infrastructure include two sub-branch openings and the commencement of operations at Qianhai Sub-branch. In July, we extended our business scope as one of the first foreign banks permitted to distribute domestic investment funds in mainland China.

Hang Seng's profit before tax rose by 30% to HK\$28,496m. Excluding the Industrial Bank reclassification, profit before tax increased by 19% to HK\$20,042m.

Operating profit excluding loan impairment charges was up 19% at HK\$18,946m. Operating profit rose by 19% to HK\$18,410m.

Net interest income grew by HK\$1,658m to HK\$18,604m, supported by the 8% increase in average interest-earning assets and a 4-basis-point improvement in net interest margin to 1.89%. Effective balance sheet management and the successful acquisition of new customers drove growth of 9% in lending and 6% in deposits.

Non-interest income rose by HK\$2,023m to HK\$9,458m, representing 33.7% of total operating income, compared with 30.5% in 2012.

With the 15% growth in net operating income before loan impairment charges outpacing the 7% rise in operating expenses, our cost efficiency ratio improved to 32.4% – down 2.5 percentage points compared with 2012.

On 31 December 2013, our total capital ratio under Basel III was 15.8% and our Common Equity Tier 1 ratio was 13.8%.

Managing for Sustainable Growth

In a rapidly changing economic and regulatory environment, our strategic priorities are designed to uphold service excellence and drive the sustainable growth of our business. We will maintain our customer-focused approach and capitalise on our competitive strengths to reinforce our position as Hong Kong's leading domestic bank and a major provider of cross-border services as economic integration in the Greater China region increases.

Backed by our deeply rooted knowledge of local markets, good cross-border connectivity and trusted brand, we are well placed to benefit from ongoing financial liberalisation on the Mainland and initiatives to internationalise the renminbi. We will strengthen our Mainland operational infrastructure

and service delivery channels and step up collaborative and cross-referral initiatives to capture increased cross-border capital and trade flows. Earlier this month, we opened a Chengdu Branch and Shanghai Free Trade Zone Sub-branch. We will continue to expand our market coverage by setting up more outlets in strategic locations.

We will enhance the end-to-end service experience for customers by making further investments in analytics, our branch network and other service delivery channels as well as in growing the skills and knowledge of staff.

Upholding high corporate governance and risk management standards remains central to our corporate value and in shaping our business for sustainable growth.

Building long-term relationships with customers, business partners and our local communities is a vital part of our ongoing success. Our commitment to helping society to prosper and flourish includes active participation in a diverse range of corporate responsibility activities.

I wish to thank our staff for their invaluable contributions to our achievements in 2013. Their dedication will ensure that we will continue to deliver service excellence to our customers and achieve optimal return for our shareholders.

Rose Lee
Vice-Chairman and Chief Executive
Hong Kong, 24 February 2014

Management Discussion and Analysis

BUSINESS IN HONG KONG

In a rapidly evolving economic environment, customers continued to value our trusted services. We worked hard to anticipate their needs – launching new products and making effective use of technology while continuing to invest in enhancing the offerings of our core banking lines. This customer-centric approach led to increases in income and profit across all business segments.

Our strong product development capabilities and close cross-border connectivity reinforced our position as a leading provider of renminbi-related products and trade-related services. Customer deposits, including certificates of deposit and other debt securities in issue, grew by 5.2% to HK\$786.5bn.

Backed by our balance sheet strength, we used our deep market insight and customer knowledge to identify good opportunities to prudently expand lending. Customer advances grew by 8.3% to HK\$526.5bn.

Retail Banking and Wealth Management

Retail Banking and Wealth Management recorded a 13.9% increase in profit before tax to HK\$8,939m. Excluding the effects of the gain arising from the disposal of our general insurance manufacturing business in 2012, profit before tax was up 16.6%.

Operating profit excluding loan impairment charges grew by 15.7% to HK\$8,967m. Operating profit was up 15.1% at HK\$8,485m.

Net interest income rose by 13.7% to HK\$9,959m, underpinned by solid growth in unsecured lending and insurance business. With the further strengthening of deposit acquisition channels as a cornerstone of our strategy for long-term growth, we invested in technology and our network of service channels to attract new customers among target groups. In the competitive market environment, this helped drive a 3.8% rise in deposits – providing additional support for the expansion of lending, which increased by 4.2%.

Non-interest income grew by 13.4% to HK\$4,334m, underpinned mainly by the 16.3% rise in net fee income. We leveraged our trusted brand and effective distribution channels to further diversify our revenue base. New investment and insurance products as well as improvements to our analytics systems and customer segmentation strategy underpinned good growth in wealth management revenue.

We improved customer convenience and choice through product and service innovations – including a first-of-its-kind near-field communication (NFC) contactless payment channel that enables Hang Seng MasterCard holders to use their smartphones to make fast, secure payments at selected retail outlets.

We expanded and enhanced our network of Prestige and Preferred Banking Centres, opening eight new outlets in 2013 to bring the total number to 12 and significantly increase our capacity to provide affluent customers with a personalised service experience. We grew the total number of Prestige and Preferred Banking customers by 7.4% compared with 2012.

Building on our strong market presence along the MTR network, we established two ‘iPoint’ sales and service centres in Central and Causeway Bay MTR Stations. These outlets provide a range of services using multimedia concept with particular appeal for busy professionals and younger customer segments.

Other investments in technology and digitally based services in 2013 include the launch of the ‘iPower’ online retail investment fund management platform.

The number of Personal e-Banking customers at 2013 year-end was 1.43 million – up 8.2% compared with a year earlier.

Wealth management

Wealth management income rose by 17.8% to HK\$6,242m, driven by successful efforts to serve key customer segments more effectively and strengthen our wealth management capabilities by expanding the product suite and emphasising a client-needs-based approach as well as through enhancements to cross-referral structures.

We capitalised on the upturn in investor outlook to achieve a 23.2% increase in investment services income to HK\$2,849m, supported mainly by growth of 42.8% in turnover of retail investment funds and the 21.6% rise in securities-related turnover. We reinforced our reputation as a leading provider of renminbi-related products as the first local financial institution to launch a Renminbi Qualified Foreign Institutional Investor (RQFII) exchange-traded fund (ETF) – the Hang Seng China A Industry Top Index ETF. Other new retail investment funds offering exposure to the mainland China A-share market include the Hang Seng China A-Share FlexiPower Fund.

Total operating income from insurance business was up 13.5% at HK\$3,393m, reflecting a 15.6% increase in annualised new life insurance premiums, a 3.6% rise in total life insurance policies in force and improved returns on the life insurance investment funds portfolio.

We continued to enrich our comprehensive life cover proposition, focusing particularly on the retiree segment with products such as our SavourLife II Annuity Life Insurance Plan, as well as whole-of-life medical protection with our new PreciousLife Critical Illness Life Insurance Plan. We also rolled out the second and third tranches of our well-received renminbi-denominated life insurance offering – the ProsperDragon Renminbi Life Insurance Plan.

Consumer finance

Loans and advances to individuals increased by 4.2% to HK\$206.1bn.

Total operating income from unsecured lending business grew by 7.6% to HK\$3,743m.

Total operating income from credit card business was up 5.8% at HK\$2,748m. Increased marketing and more effective cross-selling strategies supported a 5.0% rise in the number of credit cards in issue. Attractive promotional offers and customer loyalty helped drive a 12.9% rise in card spending, and card receivables were up 5.3%.

The personal loans balance grew by 12.9% to HK\$6,632m.

In challenging operating conditions, we leveraged our one-stop mortgage services and enhanced product offerings to sustain good momentum in our mortgage business. We grew residential mortgage lending by 3.6% and maintained a strong market position, with an average market share of 16% in 2013 in terms of new mortgage registrations.

Corporate and Commercial Banking

Corporate and Commercial Banking recorded a 7.1% increase in profit before tax to HK\$6,263m. Excluding the effects of the gain arising from the disposal of our general insurance manufacturing business in 2012, profit before tax was up 10.2%.

Operating profit excluding loan impairment charges grew by 11.9% to HK\$6,303m. Operating profit was up 10.1% at HK\$6,257m.

Net interest income rose by 9.2% to HK\$5,777m. In highly competitive market conditions, we achieved an 11.7% increase in customer deposits and grew customer advances by 11.4%.

Commercial loans rose by 13.5%, with increased lending across a broad spectrum of industry sectors. Trade finance grew by 8.9% – outpacing the 3.7% growth in Hong Kong's merchandise trade in 2013.

Non-interest income grew by 12.1% to HK\$2,356m, reflecting a 15.1% rise in net fee income and a 13.2% increase in income from foreign exchange and treasury transactions by customers. New cross-selling initiatives and enhancements to our product and service suite drove a rise in corporate wealth

management income. Investment services income grew by 22.1%, underpinned by a 47.5% rise in revenue from investment fund sales.

Targeted marketing campaigns helped us capture more cross-border trade flows to achieve a 27.8% rise in income from remittances.

New trade and supply chain solutions – including pre-delivery receivable financing under vendor-managed inventory – helped us win the ‘Hong Kong Domestic Trade Finance Bank of the Year’ award from *Asian Banking & Finance* for the second consecutive year.

We built on our position as a trusted financial partner for small and medium-sized enterprises (SMEs) to successfully attract and retain quality customers in this strategically important segment. New customers were the primary drivers of growth in SME customer deposits and the 21% increase in non-interest income from SME business. Mainland companies represented 51% of new customers in 2013 – up from 41% in 2012 – reflecting success with efforts to further leverage our extensive network of outlets and strategic alliances in southern China and the strong interconnectivity of our Mainland and Hong Kong operations.

We strengthened our service channels to enhance accessibility and convenience – opening two new Business Banking Centres in Sheung Shui and Kwun Tong, and upgrading our Business Mobile Banking platform to enable payment authorisations and fund transfers to registered third parties.

Other initiatives targeting high-value SME customers include launching the ‘UpBiz’ Integrated Account, which provides a designated trade advisory team and relationship managers. We also rolled out the UnionPay RMB Diamond Commercial Card.

The number of Business e-Banking customers at 2013 year-end was up 14.1% compared with a year earlier.

Our efforts to support home-grown businesses continue to be independently recognised. Awards received during 2013 include our eighth consecutive ‘Best SME’s Partner Award’ from The Hong Kong General Chamber of Small and Medium Business, a ‘Best SMB Partner (e-Banking)’ from *SMB World*, the ‘Excellent Brand of SME Finance Service’ from Metro Finance and the ‘Supreme Service Award (SME Banking Service)’ from *Capital CEO* and *Capital Entrepreneur*.

Treasury

Treasury recorded a 3.4% increase in profit before tax to HK\$2,441m. Operating profit was up 3.3% at HK\$2,440m.

Net interest income fell by 2.7% to HK\$1,630m, with few opportunities for yield enhancement on new and maturing proceeds under the balance sheet management portfolio in the low interest rate environment and a reduction in the commercial surplus available for deployment.

Non-interest income grew by 16.5% to HK\$1,118m, driven by a 13.7% increase in net trading income to HK\$1,123m. Assisted by an improved cross-selling strategy, we capitalised on rising demand for renminbi-denominated products. Increased investor activity supported a 23.6% rise in foreign exchange trading income.

To further diversify the revenue base, we focused on cross-business selling of appropriate treasury products, with closer collaboration helping us to better identify the specific needs of Hang Seng’s personal and commercial clients.

We remain one of the leading providers of gold investment products, launching the 10oz and 100g Hang Seng God of Wealth Gold Bars and a gold-linked structured deposit during the year. Our status as a major gold investment market player was reinforced by being awarded the exclusive right to display the world’s largest gold coin – the 2012 Australian Kangaroo One Tonne Gold Coin – in Hong Kong in early January 2014.

Hang Seng Indexes

Widely recognised as the leading compiler of indexes covering Hong Kong and mainland China, wholly owned subsidiary Hang Seng Indexes Company Limited stepped up efforts to enhance and expand its service offerings and international profile in 2013. In addition to licensing two new index-linked funds, Hang Seng Indexes introduced 13 new indexes in 2013 – the largest number ever launched by the company in a single year.

New Mainland-related additions – including the Hang Seng China A Top 100 Index, Hang Seng China A Top 500 Index and the Hang Seng China AH Smart Index – enriched Hang Seng Indexes' A-share index portfolio. These indexes also create new opportunities for the development of ETFs and index-linked funds that provide exposure to companies listed on the Shanghai and Shenzhen stock exchanges.

In June, an ETF linked to the Hang Seng High Dividend Yield Index was launched in Hong Kong. In November, Hang Seng Indexes helped break new ground by granting Hang Seng Investment Management Limited a licence to launch an RQFII ETF linked to the Hang Seng China A Industry Top Index listed on the Stock Exchange of Hong Kong – the first RQFII ETF to be launched by a domestic financial institution in Hong Kong.

Futures based on the HSI Volatility Index were certified by the US Commodity Futures Trading Commission in September.

At 31 December 2013, the number of Hang Seng Family of Indexes-linked exchange traded products worldwide was 24 – with listings on 17 different stock exchanges and a total of more than US\$16bn in assets under management. The total number of futures and options contracts traded on the Hang Seng Index and the Hang Seng China Enterprises Index in 2013 was over 59 million, representing an increase of 9.3% compared to 2012.

Following a consultation exercise to determine market participant preferences, the dissemination frequency for a number of indexes and their sub-indexes – including the Hang Seng Index and the Hang Seng China Enterprises Index – was increased from 15-second to 2-second intervals in several phases in 2013, providing investors with a more transparent and accurate view of movements in the stock market.

In July, the Hang Seng Industry Classification System was further refined to allow for the classification of stocks into 11 industries, 30 sectors and 86 subsectors, compared with 11 industries and 28 sectors under the previous structure.

Hang Seng Indexes now compiles 393 indexes – 60 real-time and 333 daily indexes – under 75 different index series, including seven cross-border series offering seven real-time and 45 daily indexes. In addition to the Hang Seng Family of Indexes, the company also compiles customised indexes to serve the specific needs of various clients.

MILESTONES

Customer convenience

Located in Hong Kong's busy Central and Causeway Bay MTR stations, our iPoint outlets bring together 'interactive', 'instant' and 'Internet' banking concepts to offer greater financial management convenience, with particular appeal for the younger generation. The outlets provide self-directed tools such as touchscreen information panels and e-Banking kiosks. The only bank providing extensive services across the MTR network, Hang Seng's development of new service delivery channels is just one example of our ongoing commitment to meeting the changing financial needs of customers.

Digitally driven

Technology is playing a growing role in our efforts to serve a busy population on the move. Our comprehensive range of Internet and mobile service channels provide financial management flexibility and freedom for customers, including more than 1.4 million individuals who currently use our Personal e-Banking platform. In June, we launched an innovative new mobile payment channel that offers shoppers the convenience of using designated near-field communication-enabled smartphones to make contactless payments at over 3,000 retail outlets.

RQFII pioneer

In November, we became the first local financial institution in Hong Kong to issue a Renminbi Qualified Foreign Institutional Investor exchange-traded fund with the launch of the Hang Seng China A Industry Top Index ETF. As part of our growing suite of renminbi products and services, the fund provides investors with direct access to the mainland China A-share market and reflects our efforts to support Hong Kong's position as the premier offshore centre for renminbi business.

Network strength

Investment in enhancing the service experience for customers in 2013 included the expansion of our network of outlets. We increased the number of Prestige and Preferred Banking Centres from four to 12 and added two new Business Banking Centres in strategic locations. These initiatives have brought us closer to target clients and significantly boost our capacity to provide tailor-made financial management solutions.

AWARDS

Best Domestic Bank in Hong Kong (for 14th consecutive year)

The Asset

The Strongest Bank Balance Sheet in Hong Kong and Asia Pacific

The Asian Banker

Most Attractive Employer in the Banking and Financial Services Sector (Hong Kong)

Randstad

Hong Kong Domestic Trade Finance Bank of the Year

Asian Banking & Finance

Best SME's Partner Award

The Hong Kong General Chamber of Small and Medium Business

Trusted Brands Gold Award – Bank (Hong Kong)

Trusted Brands Gold Award – Credit Card Issuing Bank (Hong Kong)

Reader's Digest

BUSINESS ON THE MAINLAND

In line with our plan for long-term organic growth, we strategically deployed resources to strengthen the operational infrastructure of our Mainland subsidiary bank, Hang Seng Bank (China) Limited, with investments in new outlets, technology and customer service capabilities, and took additional steps to build our brand.

Hang Seng China now has 50 outlets – 13 branches and 37 sub-branches – in 19 Mainland cities. We opened new sub-branches in Fuzhou and Shantou in 2013 and commenced operations at our Qianhai Sub-branch to capitalise on new business opportunities generated by favourable policy initiatives. Recent progress with expanding our market coverage in strategic locations include the February 2014 opening of a sub-branch in the Shanghai Free Trade Zone and a Chengdu branch. Other efforts to enhance service delivery include upgrading and expanding our online platform to provide a better customer experience and support increased cross-selling via self-guided channels. To facilitate continued business development and meet new capital requirements on the Mainland, a further RMB2bn was injected into Hang Seng China in October.

We further leveraged our cross-border capabilities and the strengths of our Hong Kong operations to provide tailor-made wealth management and trade-related financial solutions for Mainland customers, underpinned by an enriched product and service suite. Our close cross-border connectivity also provided good support for increased cross-referral business, with Mainland companies accounting for more than half of Hang Seng's new corporate customers in Hong Kong in 2013.

We successfully maintained good growth momentum, recording year-on-year increases in lending and deposits. Customer deposits rose by 17.3%, underpinning our capacity to prudently expand lending and strengthening our platform for future growth. Advances to customers increased by 18.6%.

With interest rate liberalisation, interbank market volatility and our emphasis on asset quality putting downward pressure on margins, net interest income declined by 5.7%, leading to a 4.5% drop in total operating income. As market liquidity tightened towards the end of the year, repricing of maturing facilities led to an improvement in interest margins in the fourth quarter. Non-interest income grew by 4.4%, driven by a 14.9% increase in trading income.

The slower economic growth, intensifying market competition and changes in the regulatory environment created challenging operating conditions. Operating profit was down 38.1%, due mainly to the fall in net interest income and a 7.6% increase in operating expenses due to strategic investments in our network and business infrastructure to support long-term growth.

We emphasised long-term quality growth over purely volume expansion. In our lending business, we focused on borrowers that offer good potential for generating additional revenue through cross-selling our onshore services on the Mainland and offshore services in Hong Kong. Our wealth management strength in Hong Kong proved valuable in serving the diverse investment and insurance needs of Mainland customers. In a testament to Hang Seng China's growing reputation for wealth management excellence, we were among the first foreign banks to be granted permission to distribute domestic investment funds.

We made good progress with our customer segmentation strategy. We enhanced our service proposition for affluent retail customers with the launch of our 'VIP Prestige Banking Service', which offers select clients a premium financial management experience that includes access to a range of tailored banking and wealth management services. Capitalising on our extensive network of outlets in southern China – that includes 22 Hang Seng China outlets in Guangdong – and further Government measures to facilitate cross-border trade, we established a Business Banking Department to serve the growing number of small and medium-sized enterprises whose operations include business on the Mainland and in Hong Kong.

Our commitment to exceeding customer expectations saw us win a number of products and services awards in 2013, including 'Best Cross Border Trade Settlement' from *CFO World*, 'The Best Structured Wealth Management Products' from *Securities Times* and 'The Most Competitive Award for Financial Innovation of the Year' from *Nanfang Daily*.

Our overall Mainland business reported a profit before tax of HK\$8,469m for 2013 – up 56.2% compared with a year earlier. This figure reflects the effects of a HK\$8,454m gain arising from the reclassification of Industrial Bank, a HK\$297m loss arising from the reclassification of Yantai Bank and a HK\$111m share of profit from Yantai Bank.

Future Growth

We will reach out to new customers through our strategically located Hang Seng China outlets and the extended reach provided by the close interconnections between our operations in Hong Kong and on the Mainland.

We will continue our deposits-led growth strategy, riding on our strength in wealth management, cross-border trade and connectivity to deepen customer relationships and further diversify our income base by growing our fee-based business and to generate more offshore business opportunities.

We will continue to invest in our network, systems and the development of quality service for long-term business success. We will strategically target regions, market segments and products that enable us to capitalise on our competitive advantages and pursue new opportunities created by favourable Government policy initiatives while continuing to promote closer economic ties between Hong Kong and the Mainland.

MILESTONES

Customer-driven development

Steps to extend our services on the Mainland include expanding our network of Hang Seng China outlets to support the personal finance and business needs of target customers and capitalise on growing cross-border economic ties and investment activity. We established new sub-branches in Fuzhou and Shantou in 2013 and our sub-branch in Qianhai commenced operations. In February 2014, we opened a sub-branch in the Shanghai Free Trade Zone and a branch in Chengdu to take advantage of new business opportunities.

Wealth management strength

Development of our wealth management business on the Mainland continues to be driven by the priorities of our customers. Initiatives in 2013 include the launch of our 'VIP Prestige Banking Service', through which select affluent retail clients can gain access to an array of tailored banking and wealth management services. In recognition of our growing strength and reputation, Hang Seng China was among the first foreign banks to receive authorisation to distribute domestic investment funds and received 'The Best Structured Wealth Management Products' award from *Securities Times*.

AWARDS

The Best Foreign Bank of the Year
CNFOL.COM

Best Cross Border Trade Settlement Award
CFO World

The Most Competitive Award for Financial Innovation of the Year (International Category)
Nanfang Daily

The Best Structured Wealth Management Products (Bank Category)
Securities Times

MANAGEMENT DISCUSSION AND ANALYSIS

FINANCIAL REVIEW

FINANCIAL PERFORMANCE

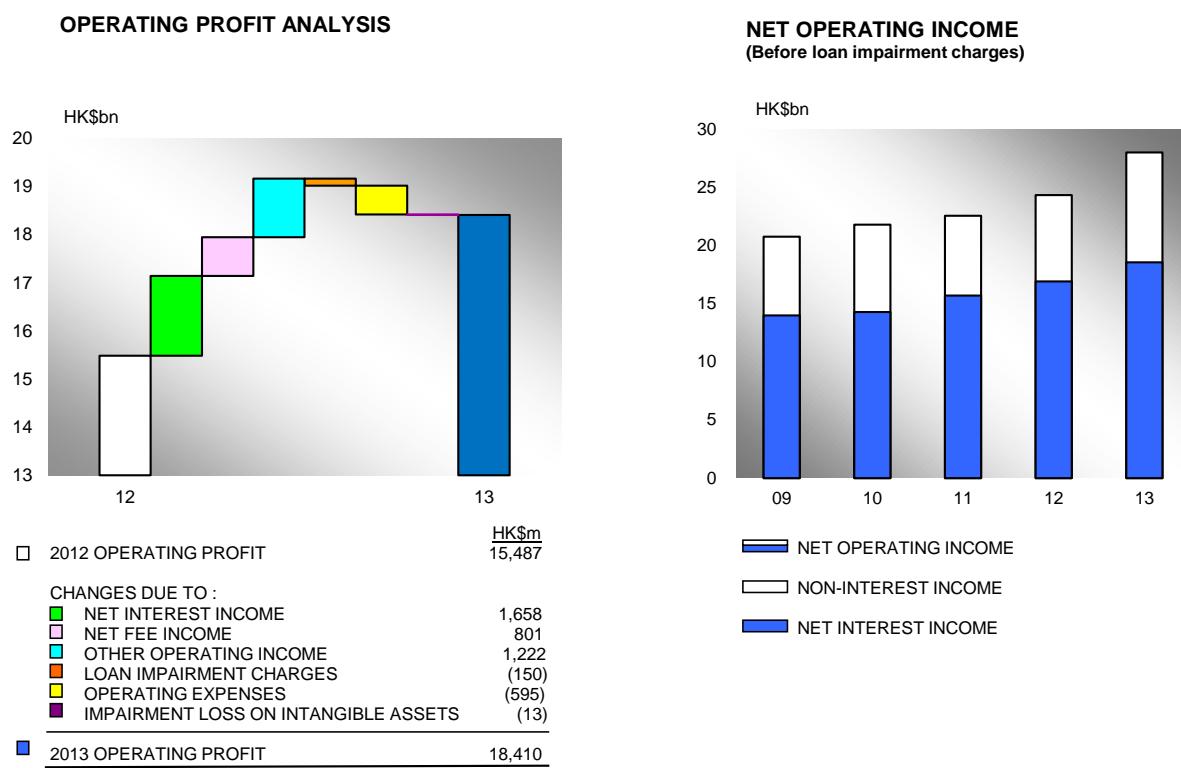
Income Statement

Summary of financial performance

<i>Figures in HK\$m</i>	2013	2012 (restated)
Total operating income	39,836	36,616
Operating expenses	9,103	8,508
Operating profit after loan impairment charges	18,410	15,487
Profit before tax	28,496	21,994
Profit attributable to shareholders	26,678	19,327
Earnings per share (in HK\$)	13.95	10.11

Hang Seng Bank Limited ('the Bank') and its subsidiaries ('the Group') reported a profit attributable to shareholders of HK\$26,678m for 2013, up 38.0% compared with 2012. Earnings per share were up by 38.0% to HK\$13.95. The attributable profit for the year included the HK\$9,517m non-distributable accounting gain on the reclassification of Industrial Bank Co., Ltd. ('Industrial Bank').

Operating profit excluding loan impairment charges grew by HK\$3,073m, or 19.4%, to HK\$18,946m. This solid result was achieved as a result of our effective execution of the Group's balanced growth strategy, which produced solid increases in operating profit across core businesses. Operating expenses rose, but to a lesser amount than the strong growth in income.



Net interest income rose by HK\$1,658m, or 9.8%, to HK\$18,604m, driven mainly by the 7.6% increase in average interest-earning assets and an improvement in the net interest margin.

<i>Figures in HK\$m</i>	<i>2013</i>	<i>2012</i>
Net interest income/(expense) arising from:		
- financial assets and liabilities that are not at fair value through profit and loss	20,242	18,162
- trading assets and liabilities	(1,697)	(1,268)
- financial instruments designated at fair value	59	52
	<u>18,604</u>	<u>16,946</u>
Average interest-earning assets	986,606	917,236
Net interest spread	1.77%	1.73%
Net interest margin	1.89%	1.85%

The rise in average interest-earning assets was underpinned by 11.7% growth in average customer lending, notably in mortgage, corporate and trade-related lending. The rise in net interest income also includes higher contributions from the insurance debt securities portfolio – which grew by 8.5% – and from offshore RMB business following the increased deployment of RMB funds in customer lending, interbank placements and debt securities.

Net interest margin and net interest spread both improved by four basis points to 1.89% and 1.77% respectively. In Hong Kong, asset spreads on customer loans widened, with improvement in spreads on term lending resulting from higher yield partly offset by the compression of spreads for trade-related lending due to keen competition. Average customer deposit balances increased and deposit spreads improved benefitting from a lower funding cost. On the Mainland, net interest margin and net interest spread were under continuous downward pressure in light of the further liberalisation of interest rates and strong competition for deposits.

Net interest income in the second half of 2013 grew by HK\$666m, or 7.4%, compared with the first half, reflecting the combined effect of an increase in average interest earning assets, widening loan spreads, improved returns from offshore RMB business, less volatility in the Mainland interbank market, and more calendar days in the second half.

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>	<i>2013</i>	<i>2012</i>
Net interest income and expense reported as "Net interest income"		
- Interest income	23,613	21,537
- Interest expense	(3,371)	(3,375)
- Net interest income	20,242	18,162
Net interest income and expense reported as "Net trading income"	(1,697)	(1,268)
Net interest income and expense reported as "Net income from financial instruments designated at fair value"	59	52
Average interest-earning assets	951,178	865,876
Net interest spread	2.03 %	2.00 %
Net interest margin	2.13 %	2.10 %

Net fees income grew across core business lines to rise by HK\$801m, or 15.7%, to HK\$5,887m.

Service enhancements and steps to diversify revenue generated a broad-based increase in net fee income.

Strong customer demand and favourable market sentiment drove the 14.0% increase in stockbroking and related services fee income and growth of 37.0% in retail investment funds fee income.

Insurance-related fee income rose by 20.2%, benefitting from the increase in non-life insurance products distribution commission during the year following the Bank's disposal of its general insurance manufacturing business in 2012, though this also led to a corresponding fall in non-life insurance underwriting profit.

Gross fee income from credit card business grew by 14.9%. The Bank's effective marketing and premium customer base supported a 12.9% rise in card spending and 5.1% increase in the number of cards in circulation. Credit facilities fee income rose by 3.9%, due mainly to higher fees from increased corporate lending.

Fees from remittances and trade-related service income recorded growth of 15.6% and 7.5% respectively, underpinned by increased business volumes.

Net trading income was broadly in line with 2012 at HK\$2,045m.

Dealing profits fell by HK\$70m, or 3.3%, to HK\$2,052m. Foreign exchange income decreased slightly, with higher foreign exchange revenues from increased customer activities and increased demand for foreign exchange option-linked structured products more than offset by lower income from funding swaps^{*} activities. Income from interest rate derivatives, debt securities, equities and other trading activities fell by HK\$48m, or 35.3%, to HK\$88m. This was primarily due to losses on equity options backing a life endowment product compared with a gain last year, which resulted in an offsetting movement in 'Net insurance claims incurred and movement in policyholders' liabilities'. Debt securities also recorded a loss compared with a gain in 2012, reflecting the movement in market interest rates. These declines were partly offset by higher gains on foreign exchange linked structured products and interest rate derivatives trading.

The net loss from hedging activities was lower than 2012 by HK\$52m.

[†] From time to time Treasury 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 HKAS 39, the exchange difference of the spot and forward contracts is required to be recognised as a foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.

Net income from financial instruments designated at fair value decreased by HK\$31m, or 8.2%, to HK\$345m, reflecting the fair value changes of assets held by the life insurance business.

To the extent that this fair value gain was attributed to policyholders of unit-linked life insurance policies, there was an offsetting movement reported under 'net insurance claims incurred and movement in policyholders' liabilities' or 'movement in present value of in-force long-term insurance business'.

Analysis of income from wealth management business

<i>Figures in HK\$m</i>	<i>2013</i>	<i>2012 (restated)</i>
Investment income:		
- retail investment funds	1,548	1,130
- structured investment products [†]	965	977
- stockbroking and related services	1,041	910
- margin trading and others	358	275
	3,912	3,292
Insurance income:		
- life insurance	3,479	3,016
- general insurance and others	207	310
	3,686	3,326
Total	7,598	6,618

[†] Income from structured investment products includes income reported under net fee income on the sales of third-party structured investment products. It also includes profits generated from the selling of structured investment products in issue, reported under net trading income.

The Bank maintained its strong position for wealth management business by leveraging its diverse portfolio of investment and insurance products to provide customers with wealth management solutions tailored to their specific needs. This supported a strong 14.8% year-on-year growth in income to HK\$7,598m.

Improved investment sentiment and customer-focused initiatives underpinned investment services income growth of 18.8% to HK\$3,912m. Sales of retail investment funds gained strong momentum to achieve a 37.0% increase in income, driven by a 42.9% rise in retail investment fund turnover. Stockbroking and related services income increased by 14.4%.

Analysis of insurance business income

Figures in HK\$m

Life insurance:

- net interest income and fee income
- investment returns on life insurance funds (including share of associate's profit and surplus on property revaluation backing insurance contracts)
- net earned insurance premiums
- net insurance claims incurred and movement in policyholders' liabilities
- movement in present value of in-force long-term insurance business

General insurance and others

Total

	2013	2012
Life insurance:		
- net interest income and fee income	3,033	2,845
- investment returns on life insurance funds (including share of associate's profit and surplus on property revaluation backing insurance contracts)	1,020	761
- net earned insurance premiums	10,005	10,774
- net insurance claims incurred and movement in policyholders' liabilities	(11,774)	(12,179)
- movement in present value of in-force long-term insurance business	1,195	815
General insurance and others	3,479	3,016
Total	<u>207</u>	<u>310</u>
	<u>3,686</u>	<u>3,326</u>

Insurance income grew by HK\$360m, or 10.8%, to HK\$3,686m.

New and enhanced insurance products offered protection strategies for a wide range of life stages. Total policies in-force and total annualised new premiums at 31 December 2013 were up 3.7% and 16.2% respectively year-on-year. In response to the low interest rate environment and to achieve stable growth in life insurance income, part of the insurance funds investment portfolio was invested in commercial property and this returned a revaluation gain in 2013.

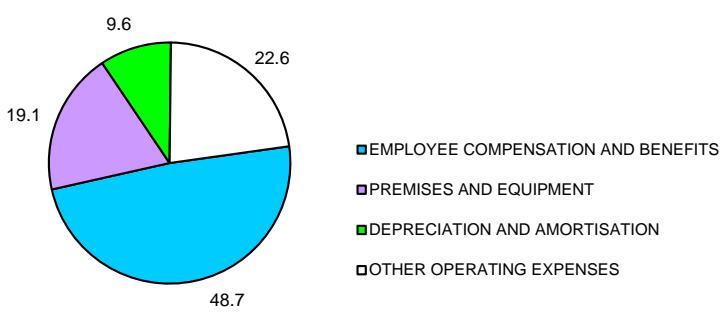
Net interest income and fee income from the life insurance investment portfolio rose by 6.6% as a result of net inflows from new and renewal life insurance business. Investment returns on life insurance funds (including the Bank's share of an associate's profit and the fair value gain on a commercial property backing insurance contracts) improved by 34.0% and were reported under 'net trading income', 'net income/(loss)' from financial instruments designated at fair value', 'other operating income' and 'share of profits from associates'. To the extent that the investment return is attributable to policyholders, there is an offsetting movement reported under 'net insurance claims incurred and movement in policyholders' liabilities' or 'movement in present value of in-force long-term insurance business'. The movement in present value of in-force long-term insurance business increased by 46.6%, due mainly to the combined effect of higher life insurance business sales during the year and updated actuarial assumptions.

General insurance business income decreased by 33.2% to HK\$207m following the completion of the disposal of our general insurance manufacturing business in the second half of 2012. The decrease in non-life insurance underwriting profit was offset by a corresponding increase in non-life insurance products distribution commission reported under 'net fee income'.

Operating expenses rose by HK\$595m, or 7.0%, compared with 2012, reflecting the Bank's continued investment in new business platforms and Mainland operations to support long-term growth.

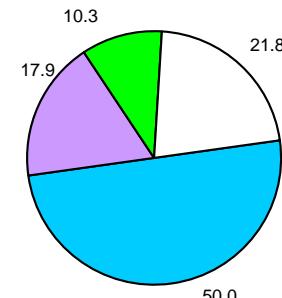
OPERATING EXPENSES FOR 2013

IN PERCENTAGE



OPERATING EXPENSES FOR 2012

IN PERCENTAGE



Employee compensation and benefits increased by HK\$176m, or 4.1%. Salaries and other costs increased by 5.0%, reflecting the annual salary increment and the increase in staff headcount. General and administrative expenses were up 12.5%, due mainly to the rise in marketing expenditure to support business growth. Rental expenses rose as a result of increased rents for branches in Hong Kong and on the Mainland. Other premises and equipment expenses also increased as a result of higher processing charges and information technology expenses.

Mainland-related operating expenses increased by 7.6% due to ongoing investment in enhancing Hang Seng China's infrastructure and service capabilities.

Full-time equivalent staff numbers by region	2013	2012
Hong Kong and others	8,001	7,797
Mainland	<u>1,855</u>	<u>1,883</u>
Total	<u><u>9,856</u></u>	<u><u>9,680</u></u>

At 31 December 2013, the Group's number of full-time equivalent staff was up by 176 compared with the end of 2012.

The Bank continued to focus on enhancing operational efficiency while maintaining growth momentum. With the increase in net operating income before loan impairment charges outpacing the growth in operating expenses, the cost efficiency ratio improved by 2.5 percentage points to 32.4%.

Operating profit rose by HK\$2,923m, or 18.9%, to HK\$18,410m.

Loan impairment charges increased by HK\$150m, or 38.9%, to HK\$536m compared with a year earlier.

<i>Figures in HK\$m</i>	2013	2012
Net charge for impairment of loans and advances to customers:		
Individually assessed impairment allowances:		
- new allowances	(191)	(294)
- releases	91	224
- recoveries	<u>16</u>	<u>13</u>
	<u>(84)</u>	<u>(57)</u>
Net charge for collectively assessed impairment allowances	<u>(452)</u>	<u>(329)</u>
Net charge for loan impairment	<u><u>(536)</u></u>	<u><u>(386)</u></u>

Overall credit quality was relatively stable with loan impairment ratios remaining at a low level.

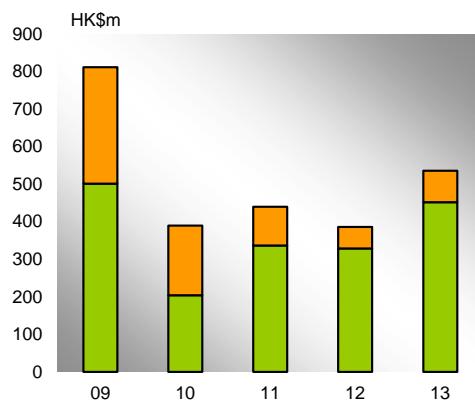
Individually assessed impairment charges rose by HK\$27m, or 47.4%, reflecting lower releases for corporate and commercial banking customers in 2013. There was a reduction in loan impairment charges for Mainland operations.

Collectively assessed impairment charges rose by HK\$123m, or 37.4%. Higher charges on the credit card and personal loan portfolios were recorded, reflecting the updated assumptions used in collective assessment models. Impairment allowances for loans not individually identified as impaired recorded a lower net release compared with 2012.

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

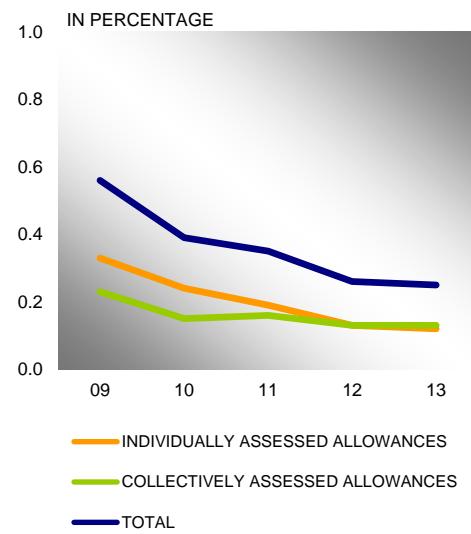
	<i>At 31 December 2013</i>	<i>At 31 December 2012</i>
	%	%
Loan impairment allowances:		
- individually assessed	0.12	0.13
- collectively assessed	0.13	0.13
Total loan impairment allowances	0.25	0.26

LOAN IMPAIRMENT CHARGES



■ COLLECTIVELY ASSESSED
■ INDIVIDUALLY ASSESSED

LOAN IMPAIRMENT ALLOWANCES AS A PERCENTAGE OF GROSS LOANS AND ADVANCES TO CUSTOMERS



Profit before tax grew by 29.6% to HK\$28,496m after taking into account a HK\$8,454m **gain on the reclassification of Industrial Bank** in January 2013 and a HK\$297m **loss on the reclassification of Yantai Bank** in December 2013; a HK\$355m decrease in **gain on the disposal of a subsidiary** – specifically, the gain of HK\$355m arising from the disposal of the Group's general insurance manufacturing business in 2012; a 53.1% (or HK\$412m) increase in **net surplus on property revaluation**; and an 89.6% (or HK\$4,819m) reduction in **share of profits from associates**, mainly reflecting the reclassification of Industrial Bank as a financial investment.

Gains less losses from financial investments and fixed assets were HK\$179m in 2013 compared with a loss of HK\$5m in 2012, due mainly to the gain on the disposal of certain properties during the year.

Net surplus on property revaluation rose by 53.1% to HK\$1,188m.

Figures in HK\$m

	<i>2013</i>	<i>2012</i>
Surplus of revaluation on investment properties	1,058	742
Surplus of revaluation on assets held for sale	133	34
Reversal of revaluation deficit on premises	<u>(3)</u>	-
	1,188	776

The Group's premises and investment properties were revalued at 30 November 2013 and updated for any material changes at 31 December 2013 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of property was market value which is consistent with the definition of fair value under HKFRS 13 'Fair Value Measurement' and takes into account the highest and best use of the property from the perspective of market participants. The highest and best use takes into account the use of the property that is physically possible, legally permissible and financially feasible as described in HKFRS 13. The net revaluation surplus for Group premises amounted to HK\$2,100m, of which HK\$2,103m was credited to the premises revaluation reserve and HK\$3m was debited to the income statement. The related deferred tax provision for Group premises was HK\$350m. Revaluation gains of HK\$1,058m on investment properties (excluding the revaluation gain on properties backing insurance contracts) and those under held for sale of HK\$133m were recognised through the income statement.

Segmental Analysis

The table below sets out the profit before tax contributed by the business segments for the years stated.

Hong Kong & other businesses

Figures in HK\$m	Retail Banking	Corporate and Commercial Management	Treasury	Other	Total	Mainland China business	Total
Year ended 31 December 2013							
Profit before tax	8,939	6,263	2,441	2,384	20,027	8,469	28,496
Share of profit before tax	31.4 %	22.0 %	8.6 %	8.3 %	70.3 %	29.7 %	100.0 %
Share of profit before tax as a % of Hong Kong & other businesses	44.6 %	31.3 %	12.2 %	11.9 %	100.0 %		
Year ended 31 December 2012 (restated)							
Profit before tax	7,851	5,850	2,361	509	16,571	5,423	21,994
Share of profit before tax	35.7 %	26.6 %	10.7 %	2.3 %	75.3 %	24.7 %	100.0 %
Share of profit before tax as a % of Hong Kong & other businesses	47.4 %	35.3 %	14.2 %	3.1 %	100.0 %		

Retail Banking and Wealth Management ('RBWM') in Hong Kong reported a 13.9% increase in profit before tax to HK\$8,939m. Excluding the disposal gain arising from the sale of the general insurance manufacturing business in 2012, profit before tax was up 16.6%. Operating profit excluding loan impairment charges rose by 15.7% to HK\$8,967m.

Net interest income grew by 13.7% to HK\$9,959m, supported by growth in unsecured lending and the insurance business. Amid keen market competition, RBWM adopted a tailored pricing strategy to attract new funds from the affluent customer segment and customer deposits grew by 3.8% compared with the end of 2012. Leveraging our strong balance sheet, we increased customer lending by 4.2%.

Non-interest income grew by 13.4% to HK\$4,334m, due mainly to the 16.3% increase in net fee income to HK\$3,849m. The successful execution of multiple initiatives to further enhance wealth management capabilities drove a 17.8% rise in wealth management income to HK\$6,242m.

The unsecured lending business remained as a strong revenue driver, with total revenue rising by 7.6%. Total credit cards in circulation rose by 5.0% to 2.46 million and we were the third largest card issuer of VISA and MasterCard. Supported by effective marketing campaigns and our quality credit card customer base, card spending and receivables grew by 12.9% and 5.3% respectively. The personal loan portfolio grew by 12.9% compared with a year earlier to HK\$6,632m.

Against a backdrop of reduced activity and tighter government measures in the property sector, we used our one-stop service proposition and diverse range of sales channels to sustain residential mortgage business momentum. We maintained our number-three market position, with an average market share of 16.0% in terms of new mortgage registrations. The residential mortgage portfolio grew by 3.6% year on year and there was modest growth in the yield.

With improved investor sentiment and increased stock market activity, we achieved a 23.2% increase in investment services income to HK\$2,849m – driven largely by the 42.8% rise in turnover of retail investment funds and the 21.6% increase in turnover of securities services. Achievements in meeting growing customer demand for renminbi-related retail investment products included becoming the first local financial institution to launch a Renminbi Qualified Foreign Institution Investor exchange-traded fund (ETF) – the Hang Seng China A Industry Top Index ETF.

Total operating income from the insurance business was up 13.5% at HK\$3,393m. Our customer driven products and promotional offers helped us grow annualised new life insurance premiums by 15.6% and total life insurance policies in-force by 3.6%. Steps to enrich our medical protection product suite included the launch of PreciousLife Critical Illness Life Insurance.

We responded to the growing demand for high quality and personalised wealth management solutions by continuing to develop strong value propositions and further enhance our service channels. This supported solid year-on-year growth in the number of Prestige and Preferred Banking customers. We expanded our number of Prestige and Preferred Banking Centres to 12. Targeting busy professionals and the young affluent customer segment, we introduced an innovative multimedia service concept with the opening of two ‘iPoint’ sales and service outlets in Central and Causeway Bay MTR stations.

Other technology-driven service enhancements in 2013 included the launch of our ‘iPower’ platform in April, which offers customers the option to manage their investment funds portfolio online and enjoy attractive subscription offers.

Corporate and Commercial Banking ('CNC') in Hong Kong reported profit before tax of HK\$6,263m - up 7.1% compared with a year earlier. Excluding the gain arising from the disposal of the general insurance manufacturing business in 2012, profit before tax was up 10.2%. Operating profit excluding loan impairment charges increased by 11.9% to HK\$6,303m.

Net interest income rose by 9.2% to HK\$5,777m. Despite strong competition, we grew customer deposits and customer loans by 11.7% and 11.4% respectively. Commercial loans increased by 13.5% and trade finance was up 8.9%.

Non-interest income increased by 12.1% to HK\$2,356m. Net fee income and net trading income grew by 15.1% and 13.2% to HK\$1,802m and HK\$505m respectively.

Investment services income rose by 22.1%, due mainly to the increase in revenue from investment fund sales and stockbroking. Foreign exchange and treasury income grew by 13.2% as our renminbi structured foreign exchange products were well-received by the market.

Through targeted marketing campaigns, we captured more cross-border fund flows to achieve a 27.8% rise in income from remittances.

We were successful in attracting and retaining new quality SME customers. Mainland companies represented 51% of newly acquired customers in 2013 – up from 41% in 2012. New customers were the primary drivers of growth in SME customer deposits and the 20.5% increase in non-interest income from SME business. Service initiatives targeting high-value SME customers included launching the ‘UpBiz’ Integrated Account with a designated trade advisory team and relationship managers, and rolling out the Hang Seng UnionPay RMB Diamond Commercial Card. We also opened two new Business Banking Centres in Sheung Shui and Kwun Tong and upgraded our Business Mobile Banking platform to enable payment authorisations and fund transfers to registered third parties.

Our support for SMEs continued to enjoy independent recognition. Awards received during 2013 include an 'SME's Best Partner Award' from the Hong Kong General Chamber of Small and Medium Business for the eighth consecutive year.

Innovative new trade and supply chain solutions – including pre-delivery receivable financing under vendor-managed inventory – helped us win the 'Hong Kong Domestic Trade Finance Bank of the Year' award from Asian Banking & Finance for the second consecutive year.

We will continue to develop new value propositions to help corporate customers strengthen their business connectivity within the Greater China region. To drive sustainable growth in customer deposits and capture more cross-border trade and fund flows, we will make further investments in transaction banking infrastructures and product development. We will step up portfolio management and optimise the return on risk-weighted assets through solution-based selling and effective bundling of wealth management and transaction banking services.

Treasury ('TRY') in Hong Kong reported profit before tax of HK\$2,441m – a year-on-year increase of 3.4%. Operating profit excluding loan impairment charges also rose by 3.4% to HK\$2,440m.

Net interest income decreased by 2.7% to HK\$1,630m. With the low interest rate environment and flattened yield curves, there were few opportunities for yield enhancement. As debt securities in the balance sheet management portfolio matured, the proceeds could only be reinvested in instruments at prevailing low rates. Our capacity to generate interest income was also adversely affected by the reduction in the commercial surplus available for deployment.

Non-interest income grew by 16.5% to HK\$1,118m. Total net trading income increased by HK\$135m, or 13.7%, to HK\$1,123m. Option income from structured products increased, due partly to our efforts to capitalise on rising demand for renminbi-denominated products. Foreign exchange trading income also recorded encouraging growth as market activity increased, particularly in the second quarter of the year.

We remained a leading provider of gold investment opportunities, launching the Hang Seng God of Wealth Gold Bar and a gold-linked structured deposit during the year.

To further diversify the revenue base, we focused on cross-selling of Global Markets products to RBWM and CNC customers, with closer collaboration helping us to better identify the specific needs of clients.

Mainland China business

With a more modest pace of domestic investment and consumption, the Mainland economy recorded moderate growth in 2013.

Interest margins were under continuous pressure with the further liberalisation of interest rates in July and tighter market liquidity working to intensify competition for deposits.

Amid these challenges, Hang Seng Bank (China) Limited ('Hang Seng China') will continue to progress its long-term growth strategy. We further strengthened our Mainland franchise through selective network expansion, tailored product offerings and improved customer segmentation strategies. At the same time, we enhanced cross-border services by continuing to build on the good connectivity between Hang Seng's Hong Kong and Mainland operations. This approach helped us maintain growth momentum to record an 18.6% increase in advances to customers and a 17.3% rise in customer deposits compared with the end of 2012.

We opened two new sub-branches during 2013 – Shantou Sub-branch and Fuzhou Gulou Sub-branch – bringing the number of outlets to 48 across 18 cities at the end of 2013. We also commenced operations at Qianhai Sub-branch. With 22 outlets in Guangdong province, our growing brand recognition and strong network in southern China created new opportunities to further develop cross-border trade business. Chengdu Branch and Shanghai Free Trade Zone Sub-branch were opened in 2014 and we will continue to expand our market coverage by opening more outlets in strategic locations.

To support the continued development of business infrastructure and meet new capital requirements of mainland China, additional capital of RMB2bn was invested in our Mainland operations in October 2013.

	<i>As reported</i>	<i>Constant currency[†]</i>
Year ended 31 December 2013 compared with 31 December 2012		
Total operating income	-4.5 %	-6.2 %
Operating profit	-38.1 %	-38.5 %
At 31 December 2013 compared with 31 December 2012		
Gross loans and advances to customers	18.6 %	14.9 %
Customer deposits	17.3 %	13.7 %

Hang Seng China's total operating income decreased by 4.5% when compared with 2012. Net interest income decreased by 5.7% as growth in interest income from customer lending was more than offset by the rise in deposit costs due to keen competition for deposits and volatility in the interbank market. Investments in network expansion and infrastructure to improve the capabilities and efficiency of Hang Seng China's operations led to a 7.6% increase in operating expenses. We continued with our prudent credit risk management strategy while growing lending to record lower loan impairment charges compared with a year earlier. As a result of the above, operating profit was down 38.1%.

The reported Mainland business results for 2013 include a HK\$8,454m gain arising from the reclassification of Industrial Bank, a HK\$297m loss arising from the reclassification of Yantai Bank and a HK\$111m share of profit from Yantai Bank. Reported results for 2012, when the Bank's investments in Industrial Bank and Yantai Bank are equity accounted for, include a HK\$5,088m share of profits from these associates.

[†] Constant currency comparatives for 2012 referred to in the tables above are computed by translating the functional currency (renminbi) of Hang Seng's mainland China business into Hong Kong dollars with respect to:

- the income statement for 2012, at the average rates of exchange for 2013; and
- the balance sheet at 31 December 2012, at the prevailing rates of exchange on 31 December 2013.

Economic Profit

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

For the year 2013, economic profit was HK\$17,268m, an increase of HK\$4,429m, or 34.5%, compared with 2012. Return on invested capital rose by HK\$6,810m.

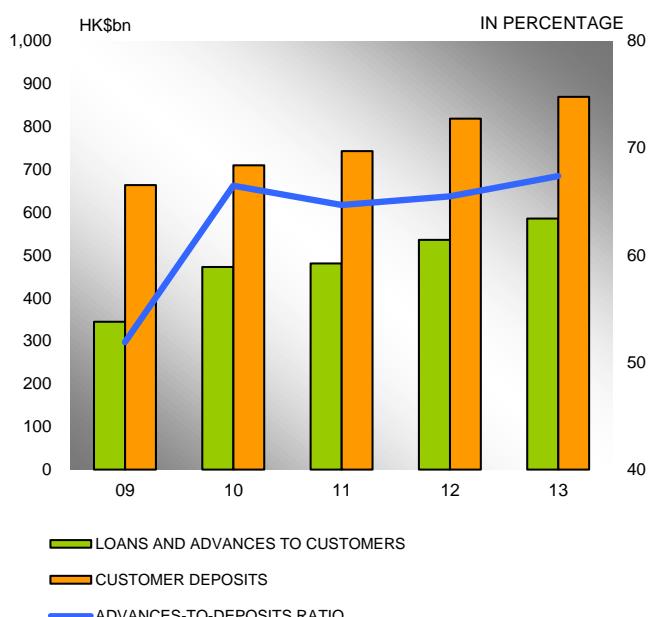
	2013 HK\$m	%	2012 HK\$m (restated)	%
Average invested capital	<u>89,789</u>		71,583	
Return on invested capital*	<u>25,781</u>	<u>28.7</u>	18,971	26.5
Cost of capital	<u>(8,513)</u>	<u>(9.5)</u>	(6,132)	(8.6)
Economic profit	<u>17,268</u>	<u>19.2</u>	12,839	17.9

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

Balance sheet

Total assets rose by HK\$66.6bn, or 6.2%, to HK\$1,143.7bn. The Group continued to pursue a balanced growth strategy in managing its assets and liabilities, and achieved stable growth in both loans and deposits. Loans and advances to customers increased by HK\$50.1bn, or 9.3%, to HK\$586.2bn, underpinned mainly by growth in the commercial and corporate lending businesses. Against a backdrop of reduced activity and government measures in the property sector, the Group maintained its strong position in residential mortgages and reported growth of 4.9% compared with the end of 2012. Trade-related lending achieved modest growth against last year end, reflecting the Bank's continued effort to deepen customer relationships. Customer deposits, including certificates of deposit and other debt securities in issue, increased by HK\$50.9bn, or 6.2%, to HK\$869.7bn. At 31 December 2013, the advances-to-deposits ratio was 67.4%, compared with 65.5% at 31 December 2012.

LOANS AND ADVANCES TO CUSTOMERS AND CUSTOMER DEPOSITS



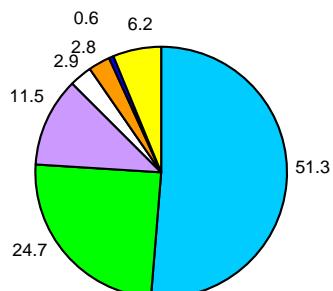
Assets Deployment

Figures in HK\$m

	2013	%	2012 (restated)	%
Cash and balances with banks	33,294	2.9	20,506	1.9
Placings with and advances to banks	131,363	11.5	140,382	13.0
Trading assets	31,996	2.8	34,399	3.2
Financial assets designated at fair value	6,987	0.6	8,343	0.8
Loans and advances to customers	586,240	51.3	536,162	49.8
Financial investments	282,845	24.7	253,408	23.5
Other assets	71,005	6.2	83,896	7.8
Total assets	1,143,730	100.0	1,077,096	100.0
Return on average total assets		2.4 %		1.9 %
Return on average total assets (excluding Industrial Bank reclassification)		1.5 %		1.4 %

ASSETS DEPLOYMENT FOR 2013

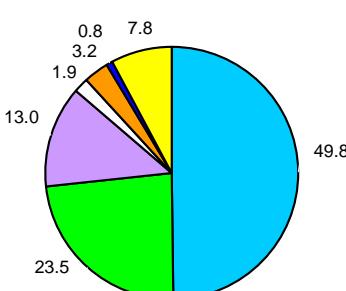
IN PERCENTAGE



- LOANS AND ADVANCES TO CUSTOMERS
- FINANCIAL INVESTMENTS
- PLACINGS WITH AND ADVANCES TO BANKS
- CASH AND BALANCES WITH BANKS
- TRADING ASSETS
- FINANCIAL ASSETS DESIGNATED AT FAIR VALUE
- OTHER ASSETS

ASSETS DEPLOYMENT FOR 2012

IN PERCENTAGE



Loans and Advances to Customers

At 31 December 2013, gross loans and advances to customers were up HK\$50.1bn, or 9.3%, at HK\$587.7bn compared with the end of 2012.

Loans for use in Hong Kong increased by HK\$23.2bn, or 6.2%. Lending to industrial, commercial and financial sectors grew by 7.2%. Lending to the property development sector increased by 2.5% while loans to the property investment sector declined by 2.7%. Lending to financial concerns fell by 22.9%, due mainly to repayments. The Bank remained a major market participant in Hong Kong Government-organised schemes to support SMEs, which, in part, helped drive growth of 33.2% in lending to the wholesale and retail trade sector and of 14.2% in loans to manufacturing businesses. Lending to the 'Other' sector grew by 33.2%, due mainly to the granting of certain new working capital financing facilities to large corporate customers.

Lending to individuals rose by 5.0% compared with the end of 2012. Against a backdrop of reduced property sector activity and government measures, the Bank was able to grow its residential mortgage portfolio by 4.9% compared with the end of 2012. Credit card loans and advances grew by 5.1%, supported by the 5.1% rise in the number of cards in circulation and the 12.9% growth in cardholder spending.

Despite trade activity remaining weak, trade-related lending grew by 9.6% compared with the end of 2012, reflecting Corporate and Commercial Banking's achievement in deepening customer relationships and strengthening its collaboration with its business partners to support trade business in particular on the Mainland.

Loans for use outside Hong Kong increased by 19.7% compared with the end of 2012, driven largely by lending on the Mainland. The Mainland loan portfolio increased by 18.6% to HK\$61.2bn, underpinned by the expansion of renminbi lending to corporate borrowers. The overall credit quality remained stable.

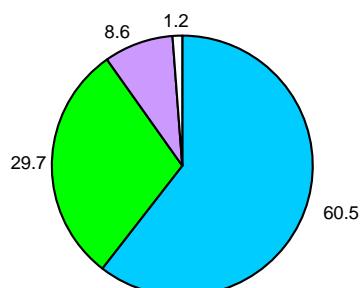
Customer Deposits

Customer deposits – including current, savings and other deposit accounts, certificates of deposit and other debt securities in issue – stood at HK\$869.7bn at 31 December 2013 – a 6.2% rise compared with the end of 2012. Deposits in Hang Seng China also rose by 17.3%, driven mainly by renminbi deposits.

At 31 December 2013, the advances-to-deposits ratio was 67.4%, compared with 65.5% at 31 December 2012.

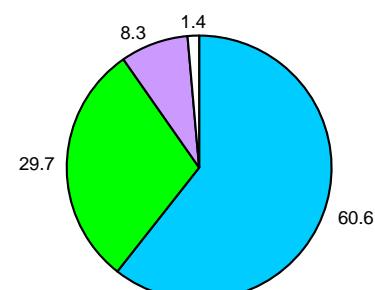
CUSTOMER DEPOSITS FOR 2013

IN PERCENTAGE



CUSTOMER DEPOSITS FOR 2012

IN PERCENTAGE



Subordinated Liabilities

The outstanding subordinated loan debts serve to help the Bank maintain a balanced capital structure and support business growth.

Shareholders' funds

Figures in HK\$m

*At 31 December
2013*

*At 31 December
2012
(restated)*

Share capital	9,559	9,559
Retained profits	78,679	59,683
Premises revaluation reserve	14,904	13,790
Cash flow hedging reserve	6	17
Available-for-sale investment reserve		
- on debt securities	(113)	(57)
- on equity securities	(1,505)	284
Capital redemption reserve	99	99
Other reserves	1,943	5,124
Total reserves	94,013	78,940
Proposed dividends	103,572	88,499
Shareholders' funds	4,206	3,824
	107,778	92,323
Return on average shareholders' funds	25.4%	22.8%
Return on average shareholders' funds (excluding Industrial Bank reclassification)	17.6%	17.1%

Shareholders' funds (excluding proposed dividends) grew by HK\$15,073m, or 17.0%, to HK\$103,572m at 31 December 2013. Retained profits rose by HK\$18,996m, mainly reflecting the 2013 profit (including the accounting gain on Industrial Bank) after the appropriation of interim dividends during the year. The premises revaluation reserve increased by HK\$1,114m, or 8.1%, mainly reflecting the improved commercial property market during the first half of 2013.

The available-for-sale investment reserve for equity securities recorded a deficit of HK\$1,505m compared with a surplus of HK\$284m at 2012 year-end, caused mainly by the share price of Industrial Bank being lower at 31 December 2013 than on reclassification as a financial investment on 7 January 2013. Changes in the fair value of the Bank's investment in Industrial Bank are recognised in the available-for-sale investment reserve unless the investment becomes impaired. If the investment becomes impaired, the cumulative revaluation deficit would be reclassified from the available-for-sale investment reserve to the income statement. The Group will continue to perform an impairment review of its investment in Industrial Bank at each balance sheet date in accordance with the Group's accounting policy on impairment of available-for-sale financial assets.

The available-for-sale investment reserve for debt securities recorded a deficit of HK\$113m compared with a deficit of HK\$57m at the end of 2012, reflecting the widening of credit spreads of debt securities in the Group's investment portfolios. The Group assessed that there were no impaired debt securities during the year, and accordingly, no impairment loss has been recognised.

Other reserves decreased by HK\$3,181m compared with 2012 year-end, reflecting the recycling of the cumulative foreign exchange and other reserves of Industrial Bank and Yantai Bank to retained profits as a result of their reclassification.

There was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities during 2013.

Management Discussion and Analysis

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

Risk Management

It is the Group's policy to provide disclosures that help investors and other stakeholders understand the Group's performance, financial position and changes thereto. In accordance with this policy, the information provided in the Notes to the Financial Statements and the Management Discussion and Analysis goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements and listing rules. Following the increased demands for enhanced risk disclosures, the Financial Stability Board established the Enhanced Disclosures Task Force ("EDTF") in May 2012 with the goal of developing principles for enhancing risk disclosures by major banks. The task force brought together senior officials and experts from financial institutions, investors and audit firms from around the world and, on 29 October 2012, the EDTF issued its report, 'Enhancing the Risk Disclosures of Banks'. The report aims to help financial institutions identify areas that investors had highlighted needed better and more transparent information about bank's risks, and how these risks relate to performance measurement and reporting. The recommendations for disclosure improvement focused on the principal risks faced by the banking industry, and included disclosures about risk governance, capital adequacy, liquidity, funding, credit risk, market risk and other risks. Following the issue of the EDTF report, the Group has provided additional disclosures in 2013 and will further enhance its risk disclosures in 2014. The Group also assesses good practice recommendations issued from time to time by relevant regulators and standard setters and will assess the applicability and relevance of such guidance, enhancing disclosures where appropriate.

All the Group's activities involve the analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The principal types of risk faced by the Group are credit risk, liquidity risk, market risk, insurance risk, operational risk and reputational risk.

The Group's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks exposures continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major risk appetite or risk control limits are approved by the Board of Directors and they are monitored and reviewed regularly by various Board or management committees, including the Executive Committee, Risk Committee, Asset and Liability Management Committee ("ALCO") and Risk Management Committee ("RMC").

The Risk Committee monitors the effectiveness of the Bank's risk management and internal controls, other than controls over financial reporting, which are monitored by the Audit Committee. As part of the monitoring process, the Risk Committee requires risk management reports from management which enable the Risk Committee to assess the risks involved in the Group's business and how they are controlled and monitored by management. It also requires reports that give clear, explicit and dedicated focus to current and forward-looking aspects of risk exposure which may require a complex assessment of the Group's vulnerability to previously unknown or unidentified risks.

Risk appetite limit is a key component of our management of risk. The Group's Risk Appetite Statement for 2013 was approved by the Board as advised by the Risk Committee, which describes the types and amount of risk that the Bank is prepared to accept in executing our business strategy.

Our risk appetite framework is underpinned by the following core characteristics:

- Strong balance sheet and brand
- Healthy capital position
- Accountable use of shareholders' funds
- Conservative liquidity management
- Risk must be commensurate with returns
- Sustainable long term growth

These core characteristics are applied to define the Risk Appetite Statement on a Bank-wide and individual risk and business level, which cover key risk types and exposures that are faced by the Group's business activities. The RMC undertook regular reviews and monitors the Group's risk profile against the limits set out in the Risk Appetite Statement and determine appropriate management action if material deviation from approved limits. Reports are submitted to the Risk Committee and Board from Chief Risk Officer on the actual profile of the Risk Appetite Statement including material deviation and management action where required.

For new products and services, in addition to the existing due diligence process, a Product Oversight Committee reporting to the RMC and comprising senior executives from Risk, Legal, Compliance, Finance, and Operations/IT, is responsible for reviewing and approving the launch of such new products and services. Each new service 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 products and services in development prior to implementation.

Description of risks - banking operations
(audited)

Risks	Arising from	Measurement, monitoring and management of risk
<i>Credit risk</i>		
The risk of financial loss if a customer or counterparty fails to meet an obligation under a contract.	Credit risk arises principally from direct lending, trade finance and leasing business, but also from certain other products such as guarantees and derivatives.	<p>Credit risk:</p> <ul style="list-style-type: none"> - is measured as the amount which could be lost if a customer or counterparty fails to make repayments. In the case of derivatives, the measurement of exposure takes into account the current mark to market value to the Group of the contract and the expected potential change in that value over time caused by movements in market rates; - is monitored within limits, approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the Group could be subjected should the customer or counterparty fail to perform its contractual obligations; and - is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.

Management Discussion and Analysis (continued)

Risk Management (continued)

Risks	Arising from	Measurement, monitoring and management of risk
Liquidity and funding risk		
The risk that the Group does not have sufficient financial resources to meet its obligations as they fall due or that it can only do so at excessive cost.	<p>Liquidity risk arises from mismatches in the timing of cash flows.</p> <p>Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.</p>	<p>Liquidity and funding risk:</p> <ul style="list-style-type: none"> - is measured using internal metrics including stressed operational cash flow projections, coverage ratio and advances to core funding ratios; - is monitored against the Group's liquidity and funding risk framework and overseen by the Group's ALCO and the RMC; and - is managed on a standalone basis with no reliance on any Group entity (unless pre-committed) or central bank unless this represents routine established business as usual market practice.
Market risk		
The risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.	<p>Exposure to market risk is separated into two portfolios:</p> <ul style="list-style-type: none"> - Trading portfolios comprise positions arising from market-making and warehousing of customer derived positions. - Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale and held to maturity, and exposures arising from our insurance operations. 	<p>Market risk:</p> <ul style="list-style-type: none"> - is measured in terms of value at risk, which is used to estimate potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence, augmented with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables; - is monitored using measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange which are applied to the market risk positions within each risk type; and - is managed using risk limits approved by the Group. These units are allocated across business lines and to the Group's legal entities.
Operational risk		
The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk (along with accounting, tax, security and fraud, people, systems, projects, operations and organisational change risk).	Operational risk arises from day to day operations or external events, and is relevant to every aspect of our business.	<p>Operational risk:</p> <ul style="list-style-type: none"> - is measured using the risk and control assessment process, which assess the level of risk and effectiveness of controls; - is monitored using key indicators and other internal control activities; and - is primarily managed by business and functional managers. They identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls utilising the operational risk management framework. The Operational Risk and Internal Control function is responsible for the framework and for overseeing the management of operational risks within businesses and functions.
Other material risks		
Reputational risk		
The risk that illegal, unethical or inappropriate behaviour by the Group itself, members of staff or clients or representatives of the Group will damage Hang Seng's reputation, leading, potentially, to a loss of business, fines or penalties.	Reputational risk encompasses negative reaction not only to activities which may be illegal or against regulations, but also to activities that may be counter to societal standards, values and expectations. It arises from a wide variety of causes, including how we conduct our business and the way in which clients to whom we provide financial services, and bodies who represent Hang Seng, conduct themselves.	<p>Reputational risk:</p> <ul style="list-style-type: none"> - is measured by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees; - is monitored through a reputational risk management framework, taking into account the results of the compliance risk monitoring activity outlined above; and - is managed by every member of staff and is covered by a number of policies and guidelines. There is a clear structure of committees and individuals charged with mitigating reputational risk, including the Group Reputational Risk Policy Committee and regional/business equivalents.

Management Discussion and Analysis (continued)

Risk Management (continued)

Risks	Arising from	Measurement, monitoring and management of risk
<i>Pension risk</i>		
The risk that contributions from Group companies and members fail to generate sufficient funds to meet the cost of accruing benefits for the future service of active members, and the risk that the performance of assets held in pension funds is insufficient to cover existing pension liabilities.	Pension risk arises from investments delivering an inadequate return, economic conditions leading to corporate failures, adverse changes in interest rates or inflation, or members living longer than expected (longevity risk). Pension risk includes operational risks listed above.	<p>Pension risk:</p> <ul style="list-style-type: none"> - is measured in terms of the schemes' ability to generate sufficient funds to meet the cost of their accrued benefits; - is monitored through the specific risk appetite that has been developed at Group level; and - is managed locally through the appropriate pension risk governance structure and through the Bank Investment Committee.

Our insurance manufacturing subsidiaries are separately regulated from our banking operations. Risks in the insurance entities are managed using methodologies and processes appropriate to insurance activities, but remain subject to oversight at Group level. Our insurance operations are also subject to the operational risks and the other material risks presented in relation to the banking operations, and these are covered by the Group's risk management processes.

Risks	Arising from	Measurement, monitoring and management of risk
<i>Description of risks – insurance manufacturing operations</i>		
<i>Financial risks</i>		
Our ability to effectively match the liabilities arising under insurance contracts with the asset portfolios that back them are contingent on the management of financial risks such as market, credit and liquidity risks, and the extent to which these risks are not borne by the policyholders.	Exposure to financial risks arises from: <ul style="list-style-type: none"> - market risk of changes in the fair values of financial assets or their future cash flows from fluctuations in variables such as interest rates, foreign exchange rates and equity prices; - credit risk and the potential for financial loss following the default of third parties in meeting their obligations; and - liquidity risk of entities not being able to make payments to policyholders as they fall due as there are insufficient assets that can be realised as cash. 	<p>Financial risks:</p> <ul style="list-style-type: none"> - are measured separately for each type of risk: - market risks are measured in terms of exposure to fluctuations in key financial variables; - credit risk is measured as the amount which could be lost if a customer or counterparty fails to make required payments; and - liquidity risk is measured using internal metrics including stressed operational cash flow projections. - are monitored within limits approved by individuals within a framework of delegated authorities; and - are managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers. Subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates and equity prices to the extent that the market exposure cannot be managed by utilising any discretionary participation (or bonus) features within the policy contracts they issue. - can be mitigated through sharing of risk with policyholders under the discretionary participation features for participating products.
Liabilities to policyholders under unit-linked contracts move in line with the value of the underlying assets, and as such the policyholder bears the majority of the financial risks.		
Contracts with discretionary participating feature ("DPF") share the performance of the underlying assets between policyholders and the shareholder in line with the type of contract and the specific contract terms.		
<i>Insurance risk</i>		
The risk that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income.	The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.	<p>Insurance risk:</p> <ul style="list-style-type: none"> - is measured in terms of life insurance liabilities for respective contract types; - is monitored by the RMC, which reviews the risk profile of the insurance operations against a risk appetite for insurance business; and - is managed both centrally and locally using product design, underwriting, reinsurance and claims-handling procedures.

Management Discussion and Analysis (continued)

Risk Management (continued)

The following information described the Group's management and control of risks, in particular, those associated with its use of financial instruments ("financial risks"). Major types of risks to which the Group was exposed include credit risk, liquidity risk, market risk, insurance risk and operational risk.

(a) Credit Risk

(audited)

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, and treasury businesses. The Group has dedicated standards, policies and procedures in place to control and monitor risk from all such activities.

There are dedicated functions, reported to Chief Risk Officer, responsible for centralised management of credit risk through:

- formulating credit policies on approval process, post disbursement monitoring, recovery process and large exposure;
- issuing guidelines on lending to specified market sectors, industries and products; the acceptability of specific classes of collateral or risk mitigations and valuation parameters for collateral;
- undertaking an independent review and objective assessment of credit risk for all commercial non-bank credit facilities in excess of designated amount prior to the facilities being committed to customers;
- controlling exposures to selected industries, counterparties, countries and portfolio types etc by setting limits;
- maintaining and developing credit risk rating/facility grading process to categorise exposures and facilitate focused management;
- reporting to senior executives and various committees on aspects of the Group loan portfolio;
- managing and directing credit-related systems initiatives; and
- providing advice and guidance to business units on various credit-related issues.

Impaired loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loan 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 sophisticated risk rating framework on counterparty credit risk based on default probability and loss estimates is implemented across the Group. The rating methodology of this framework is based upon a wide range of financial analytics. This approach will allow a more granular analysis of risk and trends. The information generated from the risk rating framework is mainly, but not exclusively, applied to credit approval, credit monitoring, pricing, loan classification and capital adequacy assessment. The Group 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.

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; and
- in the commercial real estate sector, charges over the properties being financed.

Repossessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the balance sheet within "Other assets" at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance). If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The Group does not generally occupy repossessed properties for its business use.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured.

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

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 International Swaps and Derivatives Association ("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 23 to the financial statements and credit risk concentration of respective financial assets is disclosed in notes 28, 29, 31 and 32.

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 (audited)

	Group	Bank	
	2013	2012 (restated)	2013
Cash and balances with banks	33,294	20,506	30,009
Placings with and advances to banks	<u>131,363</u>	140,382	<u>96,788</u>
Trading assets	31,968	34,369	30,449
Financial assets designated at fair value	812	4,047	-
Derivative financial instruments	6,646	5,179	5,837
Loans and advances to customers	<u>586,240</u>	536,162	<u>519,135</u>
Financial investments	254,849	253,074	167,812
Amounts due from subsidiaries	-	-	23,553
Other assets	16,483	15,429	10,481
Financial guarantees and other credit related contingent liabilities	18,970	14,793	14,618
Loan commitments and other credit related commitments	<u>394,080</u>	381,583	<u>363,897</u>
	<u>1,474,705</u>	<u>1,405,524</u>	<u>1,262,579</u>
			1,201,059

(ii) Collateral and other credit enhancements

Loans and advances

(audited)

Although collateral can be an important mitigant of credit risk, it is the Group's practice to lend on the basis of the customer's ability to meet their obligations out of their cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured. However, for certain lending decisions a charge over collateral is usually obtained, and is important for the credit decision and pricing, and it is the Bank's practice to obtain that collateral and sell it in the event of default as a source of repayment. Such collateral has a significant financial effect and the objective of the disclosure below is to quantify these forms. We may manage our risk further by employing other types of collateral and credit risk enhancements but these are harder to evaluate and subject to a greater uncertainty in the event of default, these have been described below.

We have quantified below the value of fixed charges we hold over a specific asset (or assets) of a borrower for which we have a practical ability and history of enforcing in satisfying a debt in the event of a borrower failing to meet their contractual obligations and where the asset is cash or can be realised in the form of cash by sale in an established market.

Personal lending

(audited)

For personal lending the collateral held has been analysed below separately for residential mortgages and other personal lending due to the different nature of collateral held on the portfolios.

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(ii) Collateral and other credit enhancements (continued)

Residential mortgages (audited)

The following table shows residential mortgage lending including off-balance sheet loan commitments by level of collateralisation.

Residential mortgages loans and advances

	2013	2012
Unimpaired loans		
Uncollateralised		
Fully collateralised	174,806	168,862
– Less than 25% LTV	28,306	27,588
– 25% to 50% LTV	95,095	97,653
– 51% to 75% LTV	45,296	39,363
– 76% to 90% LTV	4,061	3,563
– 91% to 100% LTV	2,048	695
Partially collateralised		
– Greater than 100% LTV (A)	20	12
– Collateral value on A	20	12
	174,826	168,874
Impaired loans		
Fully collateralised	120	155
– Less than 25% LTV	59	21
– 25% to 50% LTV	24	86
– 51% to 75% LTV	37	46
– 76% to 90% LTV	-	2
– 91% to 100% LTV	-	-
Uncollateralised	10	-
Total	174,956	169,029

The collateral included in the table above consists of fixed first charges on residential real estate.

The loan-to-value ("LTV") ratio in the table above is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date as a percentage of the current value of collateral. The current value of collateral is determined through a combination of professional valuations, physical inspections or house price indices. The collateral valuation excludes any adjustments for obtaining and selling the collateral.

Other personal lending (audited)

The remainder of our personal lending consists primarily of motor vehicle finance, credit cards, instalment loan, overdraft or revolving loan. Motor vehicle lending is generally collateralised by the motor vehicle financed. Credit cards are generally unsecured. Instalment loan, overdraft and revolving loan could be partially secured by cash or marketable securities.

Corporate and commercial and financial (non-bank) lending (audited)

For corporate and commercial and financial (non-bank) lending, the collateral held has been analysed below separately for commercial real estate and other corporate and commercial and financial (non-bank) lending due to the different nature of collateral held on the portfolios.

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(ii) Collateral and other credit enhancements (continued)

Commercial real estate (audited)

The following table shows commercial real estate lending including off-balance sheet loan commitments by level of collateralisation.

Commercial real estate loans and advances

	2013	2012
Rated - CRR/EL* 1 to 7	91,354	84,801
Uncollateralised	16,605	17,637
Fully collateralised	67,064	57,947
Partially collateralised (A)	7,685	9,217
- Collateral value on A	7,077	7,678
	91,354	84,801
Rated CRR/EL 8	2	-
Uncollateralised	-	3
Fully collateralised	-	-
- Less than 25% LTV	-	-
- 25% to 50% LTV	-	3
- 51% to 75% LTV	-	-
- 76% to 90% LTV	-	-
- 91% to 100% LTV	-	-
Partially collateralised (B)	-	-
- Collateral value on B	-	-
	2	3
Rated CRR/EL 9 to 10	-	-
Uncollateralised	1	6
Fully collateralised	-	-
- Less than 25% LTV	1	6
- 25% to 50% LTV	-	-
- 51% to 75% LTV	-	-
- 76% to 90% LTV	-	-
- 91% to 100% LTV	-	-
Partially collateralised (C)	-	-
- Collateral value on C	-	-
	1	6
Total	91,357	84,810

* For details of CRR/EL, please refer to section (iii) Credit Quality on page 42.

The collateral included in the table above consists of fixed first charges on real estate and charges over cash for the commercial real estate sector. The table includes lending to major property developers which is typically secured by guarantees or is unsecured.

The value of commercial real estate collateral is determined through a combination of professional and internal valuations and physical inspection. Due to the complexity of collateral valuations for commercial real estate, local valuation policies determine the frequency of review based on local market conditions. Revaluations are sought with greater frequency where, as part of the regular credit assessment of the obligor, material concerns arise in relation to the transaction which may reflect on the underlying performance of the collateral, or in circumstances where an obligor's credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation (i.e. the obligor's credit quality classification indicates it is at the lower end e.g. sub-standard, or approaching impaired).

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(ii) Collateral and other credit enhancements (continued)

Other corporate and commercial and financial (non-bank) lending (audited)

The following table shows corporate, commercial and financial (non-bank) lending including off-balance sheet loan commitments by level of collateralisation.

Corporate, commercial and financial (non-bank) loans and advances

	2013	2012
Rated CRR/EL 8		
Uncollateralised	13	19
Fully collateralised	112	463
– Less than 25% LTV	5	-
– 25% to 50% LTV	107	53
– 51% to 75% LTV	-	234
– 76% to 90% LTV	-	-
– 91% to 100% LTV	-	176
Partially collateralised (A)		52
– Collateral value on A	-	5
	<u>125</u>	<u>534</u>
Rated CRR/EL 9 to 10		
Uncollateralised	826	899
Fully collateralised	235	180
– Less than 25% LTV	2	-
– 25% to 50% LTV	23	21
– 51% to 75% LTV	56	23
– 76% to 90% LTV	21	-
– 91% to 100% LTV	133	136
Partially collateralised (B)	112	155
– Collateral value on B	31	61
	<u>1,173</u>	<u>1,234</u>
Total	<u><u>1,298</u></u>	<u><u>1,768</u></u>

The collateral used in the assessment of the above primarily includes first legal charges over real estate and charges over cash in the commercial and industrial sector and charges over cash and marketable financial instruments in the financial sector. Government sector lending is typically unsecured.

It should be noted that the table above excludes other types of collateral which are commonly taken for corporate and commercial lending such as unsupported guarantees and floating charges over the assets of a customer's business. While such mitigants have value, often providing rights in insolvency, their assignable value is insufficiently certain. They are assigned no value for disclosure purposes.

As with commercial real estate the value of real estate collateral included in the table above is generally determined through a combination of professional and internal valuations and physical inspection. The frequency of revaluation is undertaken on a similar basis to commercial real estate loans and advances; however, for financing activities in corporate and commercial lending that are not predominantly commercial real estate-oriented, collateral value is not as strongly correlated to principal repayment performance. Collateral values will generally be refreshed when an obligor's general credit performance deteriorates and it is necessary to assess the likely performance of secondary sources of repayment should reliance upon them prove necessary. For this reason, the table above reports values only for customers with CRR 8 to 10, reflecting that these loans and advances generally have valuations which are of comparatively recent vintage. In addition, collateral values held for customers rated CRR 9 to 10 are separately disclosed above, starting with 2013. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(ii) Collateral and other credit enhancements (continued)

Loans and advances to banks (audited)

The following table shows loans and advances to banks including off-balance sheet loan commitments by level of collateralisation.

Loans and advances to banks

	2013	2012
Rated CRR/EL 1 to 8		
Uncollateralised	131,363	140,382
Fully collateralised	-	-
Partially collateralised (A)	-	-
– Collateral value on A	[redacted]	[redacted]
	131,363	140,382
Rated CRR/EL 9 to 10		
Uncollateralised	-	-
Fully collateralised	-	-
Partially collateralised (B)	-	-
– Collateral value on B	[redacted]	[redacted]
	131,363	140,382
Total loans and advances to banks	131,363	140,382

Derivatives (audited)

The ISDA Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of 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 another pre-agreed termination event occurs. It is common, and the Group's preferred practice, for the parties to execute a Credit Support Annex ("CSA") in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institutional clients.

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(ii) Collateral and other credit enhancements (continued)

Other credit risk exposures (audited)

In addition to collateralised lending described above, other credit enhancements are employed and methods used to mitigate credit risk arising from financial assets. These are described in more detail below.

Government, bank and other financial institution issued securities may benefit from additional credit enhancement, notably through government guarantees that reference these assets. Corporate issued debt securities are primarily unsecured. Debt securities issued by banks and financial institutions include covered bonds, which are supported by underlying pools of financial assets.

Trading assets include loans and advances held with trading intent, the majority of which consist of reverse repos and securities borrowing which by their nature are collateralised. Collateral accepted as security that the Group is permitted to sell or repledge under these arrangements is described in Note 52 "Assets pledged as security for liabilities and collateral accepted as security for assets".

The Group's maximum exposure to credit risk includes financial guarantees and similar arrangements that it issues or enters into, and loan commitments to which it is irrevocably committed. Depending on the terms of the arrangement, the Bank may have recourse to additional credit mitigation in the event that a guaranteee is called upon or a loan commitment is drawn and subsequently defaults. The risks and exposures from these are captured and managed in accordance with the Group's overall credit risk management policies and procedures.

**Collateral and other credit enhancements obtained
(audited)**

The Group obtained assets by taking possession of collateral held as security, or calling other credit enhancement.

The carrying amount outstanding as at the year end was as follows:

	Group		Bank	
	2013	2012	2013	2012
Nature of assets:				
Residential properties	9	16	8	14
Commercial and industrial properties	-	-	-	-
Other	-	-	-	-
	9	16	8	14

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(iii) Credit quality (audited)

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

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

(unaudited)

Quality classification	Wholesale lending and derivatives	Retail lending	Debt securities/other
Strong	CRR 1 to CRR 2	EL 1 to EL 2*	A- and above
Medium	CRR 3 to CRR 5	EL 3 to EL 5*	B+ to BBB+ and unrated
Sub-standard	CRR 6 to CRR 8	EL 6 to EL 8*	B and below
Impaired	CRR 9 to CRR 10	EL 9 to EL 10 and all EL 1 to EL 8 exposures past due 90 days and above	Individually identified

* All retail exposures past due 90 days and above are classified as "impaired".

Quality classification definitions:

(audited)

- Strong: Exposures demonstrate a strong capacity to meet financial commitments, with 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 satisfactory 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 accounts show longer delinquency periods of up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate through security realisation or other recovery processes.
- Impaired: Exposures have been assessed, individually or collectively, as impaired. The Group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail expected loss ("EL") grade, whereby in the higher quality grades the grading assignment will reflect the offsetting impact by credit risk mitigation in one form or another.

The Group's policy in respect of impairment on loans and advances and debt securities is set out in note 3 on the financial statements. Analysis of impairment allowances as at 31 December 2013 and the movement of such allowances during the year are disclosed in note 31.

Granular risk rating scales:

(unaudited)

The customer risk rating ("CRR") 10-grade scale maps to a more granular underlying 23-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which regulatory approach is adopted for the assets in question. The expected loss ("EL") 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

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 income statement. Consequently, all such balances are reported under "neither past due nor impaired".

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(iii) Credit quality (continued)

Distribution of financial instruments by credit quality
(audited)

	Group						Total
	Neither past due nor impaired	Past due	Impaired	Impairment allowances			
	Strong	Medium*	Sub-standard	not impaired	Impaired		
2013							
Items in the course of collection from other banks	4,349	394	-	-	-	-	4,743
Trading assets:							
- treasury and eligible bills	18,336	-	-	-	-	-	18,336
- debt securities	5,268	203	-	-	-	-	5,471
- loans and advances to banks	5,950	2,200	-	-	-	-	8,150
- loans and advances to customers	11	-	-	-	-	-	11
	<u>29,565</u>	<u>2,403</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>31,968</u>
Financial assets designated at fair value:							
- treasury and eligible bills	-	-	-	-	-	-	-
- debt securities	569	243	-	-	-	-	812
- loans and advances to banks	-	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-	-
	<u>569</u>	<u>243</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>812</u>
Derivatives	5,880	727	39	-	-	-	6,646
Loans and advances held at amortised cost:							
- balances/placings with and advances to banks	142,745	15,907	-	-	-	-	158,652
- loans and advances to customers	305,724	274,793	1,589	4,271	1,311	(1,448)	586,240
	<u>448,469</u>	<u>290,700</u>	<u>1,589</u>	<u>4,271</u>	<u>1,311</u>	<u>(1,448)</u>	<u>744,892</u>
Financial investments:							
- treasury and similar bills	91,811	-	-	-	-	-	91,811
- debt securities	155,040	7,998	-	-	-	-	163,038
	<u>246,851</u>	<u>7,998</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>254,849</u>
Other assets:							
- acceptances and endorsements	879	5,420	52	-	-	-	6,351
- other	2,232	3,081	3	73	-	-	5,389
	<u>3,111</u>	<u>8,501</u>	<u>55</u>	<u>73</u>	<u>-</u>	<u>-</u>	<u>11,740</u>

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(iii) Credit quality (continued) (audited)

	Group							Total	
	Neither past due nor impaired			Past due not impaired		Impairment allowances			
	Strong	Medium*	Sub- standard	Impaired					
2012									
Items in the course of collection from other banks	5,418	224	-	-	-	-	-	5,642	
Trading assets:									
- treasury and eligible bills	26,808	-	-	-	-	-	-	26,808	
- debt securities	6,161	345	-	-	-	-	-	6,506	
- loans and advances to banks	1,045	-	-	-	-	-	-	1,045	
- loans and advances to customers	10	-	-	-	-	-	-	10	
	<u>34,024</u>	<u>345</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>34,369</u>	
Financial assets designated at fair value:									
- treasury and eligible bills	-	-	-	-	-	-	-	-	
- debt securities	3,905	142	-	-	-	-	-	4,047	
- loans and advances to banks	-	-	-	-	-	-	-	-	
- loans and advances to customers	-	-	-	-	-	-	-	-	
	<u>3,905</u>	<u>142</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,047</u>	
Derivatives	4,604	539	36	-	-	-	-	5,179	
Loans and advances held at amortised cost:									
- balances/placings with and advances to banks	142,365	14,058	-	-	-	-	-	156,423	
- loans and advances to customers	312,427	218,657	2,031	3,116	1,340	(1,409)	536,162		
	<u>454,792</u>	<u>232,715</u>	<u>2,031</u>	<u>3,116</u>	<u>1,340</u>	<u>(1,409)</u>	<u>536,162</u>	<u>692,585</u>	
Financial investments:									
- treasury and similar bills	98,262	-	-	-	-	-	-	98,262	
- debt securities	146,159	8,653	-	-	-	-	-	154,812	
	<u>244,421</u>	<u>8,653</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>253,074</u>	
Other assets:									
- acceptances and endorsements	1,120	4,143	1	-	-	-	-	5,264	
- other	2,187	2,309	4	23	-	-	-	4,523	
	<u>3,307</u>	<u>6,452</u>	<u>5</u>	<u>23</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>9,787</u>	

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(iii) Credit quality (continued) (audited)

	Bank						Total	
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances		
	Strong	Medium*	Sub- standard					
2013								
Items in the course of collection from other banks	4,348	394	-	-	-	-	4,742	
Trading assets:								
- treasury and eligible bills	18,336	-	-	-	-	-	18,336	
- debt securities	3,952	-	-	-	-	-	3,952	
- loans and advances to banks	5,950	2,200	-	-	-	-	8,150	
- loans and advances to customers	11	-	-	-	-	-	11	
	<u>28,249</u>	<u>2,200</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>30,449</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>	
Derivatives	5,342	459	36	-	-	-	5,837	
Loans and advances held at amortised cost:								
- balances/placings with and advances to banks	113,406	7,649	-	-	-	-	121,055	
- loans and advances to customers	281,619	232,617	1,317	3,629	1,097	(1,144)	519,135	
	<u>395,025</u>	<u>240,266</u>	<u>1,317</u>	<u>3,629</u>	<u>1,097</u>	<u>(1,144)</u>	<u>640,190</u>	
Financial investments:								
- treasury and similar bills	91,811	-	-	-	-	-	91,811	
- debt securities	74,460	1,541	-	-	-	-	76,001	
	<u>166,271</u>	<u>1,541</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>167,812</u>	
Other assets:								
- acceptances and endorsements	471	2,783	-	-	-	-	3,254	
- other	923	1,550	2	10	-	-	2,485	
	<u>1,394</u>	<u>4,333</u>	<u>2</u>	<u>10</u>	<u>-</u>	<u>-</u>	<u>5,739</u>	

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(iii) Credit quality (continued) (audited)

	Bank						
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium*	Sub- standard				
2012							
Items in the course of collection from other banks	5,418	224	-	-	-	-	5,642
Trading assets:							
- treasury and eligible bills	26,808	-	-	-	-	-	26,808
- debt securities	3,742	-	-	-	-	-	3,742
- loans and advances to banks	1,045	-	-	-	-	-	1,045
- loans and advances to customers	10	-	-	-	-	-	10
	<u>31,605</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>31,605</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>
Derivatives	4,208	399	27	-	-	-	4,634
Loans and advances held at amortised cost:							
- balances/placings with and advances to banks	81,525	7,364	-	-	-	-	88,889
- loans and advances to customers	288,330	184,735	1,121	2,511	1,120	(1,083)	476,734
	<u>369,855</u>	<u>192,099</u>	<u>1,121</u>	<u>2,511</u>	<u>1,120</u>	<u>(1,083)</u>	<u>565,623</u>
Financial investments:							
- treasury and similar bills	98,262	-	-	-	-	-	98,262
- debt securities	45,215	1,831	-	-	-	-	47,046
	<u>143,477</u>	<u>1,831</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>145,308</u>
Other assets:							
- acceptances and endorsements	599	1,949	-	-	-	-	2,548
- other	632	930	-	1	-	-	1,563
	<u>1,231</u>	<u>2,879</u>	<u>-</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>4,111</u>

* Includes HK\$5,437 million (2012: HK\$5,233 million) and HK\$745 million (2012: HK\$615 million) of debt securities that have been classified as BBB- to BBB+ for the Group and the Bank respectively in 2013, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit Risk (continued)

(iii) Credit quality (continued)

Aging analysis of financial instruments which were past due but not impaired (audited)

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					
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	Total
2013						
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	-	-	-	-	-	-
	-	-	-	-	-	-
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	-	-	-	-	-	-
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- balances/placings with and advances to banks	-	-	-	-	-	-
- loans and advances to customers [#]	3,731	467	72	1	-	4,271
	3,731	467	72	1	-	4,271
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	-	-	-	-	-	-
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	63	5	2	3	-	73
	63	5	2	3	-	73

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit risk (continued)

(iii) Credit quality (continued) (audited)

	Group					
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	Total
2012						
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	-	-	-	-	-	-
	=====	=====	=====	=====	=====	=====
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	=====	=====	=====	=====	=====	=====
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- balances/placings with and advances to banks	-	-	-	-	-	-
- loans and advances to customers [#]	2,663	353	96	4	-	3,116
	=====	=====	=====	=====	=====	=====
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	=====	=====	=====	=====	=====	=====
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	14	4	3	2	-	23
	=====	=====	=====	=====	=====	=====

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit risk (continued)

(iii) Credit quality (continued) (audited)

	Bank					
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	Total
2013						
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	-	-	-	-	-	-
	—	—	—	—	—	—
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	—	—	—	—	—	—
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- balances/placings with and advances to banks	-	-	-	-	-	-
- loans and advances to customers [#]	<u>3,203</u>	<u>365</u>	<u>60</u>	<u>1</u>	<u>-</u>	<u>3,629</u>
	<u>3,203</u>	<u>365</u>	<u>60</u>	<u>1</u>	<u>-</u>	<u>3,629</u>
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	—	—	—	—	—	—
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	<u>9</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>10</u>
	<u>9</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>10</u>

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit risk (continued)

(iii) Credit quality (continued) (audited)

	Bank					
	Up to 29 days	30- 59 days	60- 89 days	90- 180 days	Over 180 days	Total
2012						
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	-	-	-	-	-	-
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Financial assets designated at fair value:						
- treasury and eligible bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
- loans and advances to banks	-	-	-	-	-	-
- loans and advances to customers	-	-	-	-	-	-
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Derivatives	-	-	-	-	-	-
Loans and advances held at amortised cost:						
- balances/placings with and advances to banks	-	-	-	-	-	-
- loans and advances to customers [#]	2,182	248	77	4	-	2,511
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Financial investments:						
- treasury and similar bills	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Other assets:						
- acceptances and endorsements	-	-	-	-	-	-
- other	1	-	-	-	-	1
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

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

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit risk (continued)

(iii) Credit quality (continued)

Impaired loans and advances ***(audited)***

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 3(d) to the financial statements.

Analysis of impairment allowances at 31 December 2013 and the movement of such allowances during the year are disclosed in note 31 to the financial statements.

Impaired loans and advances are those that meet any of the following criteria:

- wholesale loans and advances classified as CRR 9 or CRR 10. These grades are assigned when the bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse to security, or when the customer is past due 90 days or more on any material credit obligation to the Group;

- retail loans and advances:

- classified as EL 9 or EL 10;
- classified as EL 1 to EL 8 with 90 days and over past due;
- that have been with either 90 days and over past due or with economic loss incurred by the Group irrespective of the delinquency status; or
- that were 90 days and over past due at the point of re-age.

- renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment. For loans that are assessed for impairment on a collective basis, the evidence to support reclassification as no longer impaired typically comprises a history of payment performance against the original or revised terms, depending on the nature and volume of renegotiation and the credit risk characteristics surrounding the renegotiation. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case by case basis.

Management Discussion and Analysis (continued)

Risk Management (continued)

(a) Credit risk (continued)

(iii) Credit quality (continued)

Impairment assessment (audited)

It is Group's policy that each operating company in the Group creates impairment allowances for impaired loans promptly and appropriately.

For details of our impairment policies on loans and advances and financial investments, see notes 3(d) and 3(s) on the financial statements.

Impairment and credit risk mitigation

The existence of collateral has an impact when calculating impairment on individually assessed impaired loans. When we no longer expect to recover the principal and interest due on a loan in full or in accordance with the original terms and conditions, it is assessed for impairment. If exposures are secured, the current net realisable value of the collateral will be taken into account when assessing the need for an impairment allowance. No impairment allowance is recognised in cases where all amounts due are expected to be settled in full on realisation of the security.

Personal lending portfolios are generally assessed for impairment on a collective basis as the portfolios typically consist of large groups of homogeneous loans. Two methods are used to calculate allowances on a collective basis: a roll rate methodology or a more basic formulaic approach based on historical losses. In 2013 we reviewed the impairment allowance methodology used for retail banking and small business portfolios across the Group to ensure that the assumptions used in our collective assessment models continue to appropriately reflect the period of time between a loss event occurring and the account proceeding to delinquency and eventual write-off.

The historical loss methodology is typically used to calculate collective impairment allowances for secured, or low default portfolios such as mortgages, until the point at which they are individually identified and assessed as impaired. For loans which are collectively assessed using historical loss methodology, the historical loss rate is derived from the average contractual write-off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after the realisation of collateral and receipt of recoveries.

A roll rate methodology is more commonly adopted for unsecured portfolios when there are sufficient volumes of empirical data to develop robust statistical models. In these cases a roll rate methodology is applied until the point at which the loans are individually identified and assessed as impaired, and the average loss rate for each delinquency bucket is adjusted to reflect the average loss expected following realisation of security and receipt of recoveries. The average loss expected is derived from average historical collateral realisation values.

The nature of the collective allowance assessment prevents individual collateral values or LTV ratios from being included within the calculation. However, the loss rates used in the collective assessment are adjusted for the collateral realisation experiences which will vary depending on the LTV composition of the portfolio.

For wholesale collectively assessed loans historical loss methodologies are applied to measure loss event impairments which have been incurred but not reported. Loss rates are derived from the observed contractual write-off net of recoveries over a defined period of at least 60 months. The net contractual write-off rate is the actual amount of loss experienced after realisation of collateral and receipt of recoveries. These historical loss rates are adjusted by an economic factor which adjusts the historical averages to better represent current economic conditions affecting the portfolio. In order to reflect the likelihood of a loss event not being identified and assessed an emergence period assumption is applied. This reflects the period between a loss occurring and its identification. The emergence period is estimated by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behavior, portfolio management information, credit management techniques and collection and recovery experiences in the market. A fixed range for the period between a loss occurring and its identification is not defined across the Group and as it is assessed empirically on a periodic basis, it may vary over time as these factors change. Given that credit management policies require all customers to be reviewed at least annually, we expect this estimated period would be at most 12 months.

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (audited)

The purpose of liquidity management is to ensure sufficient cash flows to meet all financial commitment and to capitalise on opportunities for business expansion. This includes the Group's ability to meet deposit withdrawals either on demand or at contractual maturity, to repay borrowings as they mature, to comply with the statutory liquidity ratio, and to make new loans and investments as opportunities arise. The Group maintains a stable and diversified funding base of core retail and corporate customer deposits as well as portfolios of highly liquid assets.

As part of our Asset, Liability and Capital Management structure, we have established Asset and Liability Management Committee ("ALCO") at Group level and in operating entities. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding. Management of liquidity is carried out both at Group and Bank levels 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 ALCO. Liquidity is managed on a daily basis by the Bank's treasury functions and overseas treasury sites.

The Board is ultimately responsible for determining the types and magnitude of liquidity risk that the Group is able to take and ensure that there is an appropriate organisation structure for managing this risk. Under authorities delegated by the Executive Committee, the Group ALCO is responsible for managing all Asset, Liability and Capital Management issues including liquidity and funding risk management.

The Group ALCO delegates to the Group Tactical Asset and Liability Management Committee ("TALCO") the task of reviewing various analyses of the Group pertaining to site liquidity and funding. TALCO's primary responsibilities include but are not limited to:

- reviewing the funding structure of operating entities and the allocation of liquidity among them;
- reviewing operating entities' list of liquid securities and documented proof that a deep and liquid market exists; and
- monitoring liquidity and funding limit breaches and providing direction to those operating entities that have not been able to rectify breaches on a timely basis.

Compliance with liquidity and funding requirements is monitored by the ALCO and is reported to the Risk Management Committee ("RMC"), Executive Committee, Risk Committee and the Board of Directors on a regular basis. This process includes:

- maintaining compliance with relevant regulatory requirements of the reporting entity;
- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to core funding ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined limits;
- 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
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

The management of liquidity and funding risk (audited)

Inherent liquidity risk categorisation

The Group places its significant operating entities into one of three categories (low, medium and high) to reflect the assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the host country and factors specific to the significant operating entities themselves, such as the local market, market share and balance sheet strength. The categorisation involves management judgement and is based on the perceived liquidity risk of the significant operating entity relative to other entities in the Group. The categorisation is intended to reflect the possible impact of a liquidity event, not the probability of an event. The categorisation is part of the Group risk appetite and is used to determine the prescribed stress scenario that the Group requires its significant operating entities to be able to withstand and manage.

Core deposits

A key assumption of our internal framework is the categorisation of customer deposits into core and non-core based on our expectation of the behaviour of these deposits during a liquidity stress. This characterisation takes into account the Group's inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer, the size of customer's total balance and pricing of the deposit. The core deposit base in each operating entity is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that we use to calculate our principal liquidity risk metrics.

The three filters considered in assessing whether a deposit in any operating entity is core/non-core are:

- price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;
- size: depositors with total balances above certain monetary thresholds, the excess balances are classified as non-core. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and
- line of business: the element of any deposit remaining after the application of the price and size filter is assessed on the basis of the line of business and inherent liquidity risk categorisation to which the deposit is associated

Repo transactions and bank deposits cannot be categorised as core deposits.

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

Advances to core funding ratio

The Group's liquidity and funding risk management framework ("LFRF") employs two key measures to define, monitor and control the liquidity and funding risk of each of the Group's operating entities. The advances to core funding ratio is used to monitor the structural long-term funding position, and the stressed coverage ratio, incorporating Group standard stress scenarios, is used to monitor the resilience to severe liquidity stresses.

Core customer deposits are an important source of funds to finance lending to customers, and mitigate against reliance on short-term wholesale funding. Limits are placed on operating entities to restrict our ability to increase loans and advances to customers without corresponding growth in core customer deposits or long-term debt funding with a residual maturity beyond one year. This measure is referred to as the "advances to core funding" ratio.

Advances to core funding ratio limits are set by the ALCO for the most significant operating entities. The ratio describes current loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. In general, customer loans are assumed to be renewed and are included in the numerator of the advances to core funding ratio, irrespective of the contractual maturity date. Reverse repurchase arrangements are excluded from the advances to core funding ratio.

Stressed coverage ratio

Stressed coverage ratios tabulated below are derived from stressed cash flow scenario analyses and express the stressed cash inflows as a percentage of stressed cash outflows over one-month and three-month time horizons.

The stressed cash inflows include:

- inflows (net of assumed haircuts) expected to be generated from the realisation of liquid assets; and
- contractual cash inflows from maturing assets that are not already reflected as a use of liquid assets.

In line with the approach adopted for the advances to core funding ratio, customer loans are, in general, assumed not to generate any cash inflows under stress scenarios and are therefore excluded from the numerator of the stressed coverage ratios, irrespective of the contractual maturity date.

A stressed coverage ratio of 100% or higher reflects a positive cumulative cash flow under the stress scenario being monitored. Group operating entities are required to maintain a ratio of 100% or greater up to three months under the Group standard stress scenario defined by the inherent risk categorisation of the operating entity concerned.

Advances to core funding ratios and the stressed one-month and three-month coverage ratios for the Group are provided in the following table based on month end figures.

	Advances to core funding ratio (unaudited)		Stressed one month covering ratio (unaudited)		Stressed three month covering ratio (unaudited)	
	2013 %	2012 %	2013 %	2012 %	2013 %	2012 %
Year-end	83.9	81.6	147.6	161.6	148.1	160.7
Maximum	86.9	83.9	155.6	161.6	150.2	160.7
Minimum	82.0	81.6	136.0	137.9	135.9	136.7
Average	84.3	82.7	146.8	147.9	145.3	142.9

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

Stressed scenario analysis (audited)

The Group uses a number of standard and local stress scenarios designed to model:

- institution-specific crisis scenarios;
- general market crisis scenarios; and
- combined scenarios.

These scenarios are modelled by the relevant operating entities. The appropriateness of the assumptions for each scenario is reviewed regularly and formally approved by the ALCO, RMC, Risk Committee and the Board annually as part of the liquidity and funding risk appetite approval process.

Stressed cash outflows are determined by applying a standard set of prescribed stress assumptions to the Group's cash flow model. In addition to the standard stress scenarios, individual operating entities are required to design their local scenarios to reflect specific local market conditions, products and funding bases.

Liquid assets (unaudited)

The table below shows the estimated liquidity value (before assumed haircuts) of assets categorised as liquid used for the purposes of calculating the three-month stressed coverage ratios, as defined under the LFRF.

Any unencumbered asset held as a consequence of a reverse repo transaction with a residual contractual maturity within the stressed coverage ratio time period and unsecured interbank loans maturing within three months are not included in liquid assets, as these assets are reflected as contractual cash inflows.

Liquid assets are held and managed on a standalone operating entity basis. Most of the liquid assets shown are held directly by each operating entity's Balance Sheet Management function, primarily for the purpose of managing liquidity risk, in line with the LFRF.

Internal categorisation	Cash recognised	Asset classes	Eligibility Criteria
Level 1	Within one month	<ul style="list-style-type: none">- Central government- Central bank (including confirmed withdrawable reserves)- Supranationals- Multilateral development banks	0% and 20% Risk Weighted
Level 2	Within one month but capped	<ul style="list-style-type: none">- Local and regional government- Public sector entities- Secured covered bonds and pass-through ABSs- Gold	20% Risk Weighted
Level 3	Within one to three months	<ul style="list-style-type: none">- Unsecured non-financial entity securities- Equities listed on recognised exchanges and within liquid indices	Internally rated 2.2 CRR or better

Any entity owned and controlled by central or local/regional government but not explicitly guaranteed is treated as a public sector entity. Any exposure explicitly guaranteed is reflected as an exposure to the ultimate guarantor.

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

Liquid assets of the Group (unaudited)	2013	2012
Level 1	140,964	154,857
Level 2	19,825	13,748
Level 3	3,296	2,330
	164,085	170,935

All assets held within the liquid asset portfolio are unencumbered.

Liquid assets held by the Group decreased as a result of the reduction of commercial surplus. As the growth in customers loans and advances exceeded the increases in core deposits from customers, matured liquid assets were redeployed to support the loans and advances to customers and the level of liquid assets held decreased accordingly.

Stressed scenario analysis and the numerator of the coverage ratio include the assumed cash inflows that would be generated from the realisation of liquid assets, after applying the appropriate stressed haircut. These assumptions are made based on management's expectation of when an asset is deemed to be realisable.

Liquid assets are unencumbered assets that meet the Group's definition of liquid assets and are either held outright or as a consequence of a reverse repo transaction with a residual contractual maturity beyond the time horizon of the stressed coverage ratio being monitored.

The Group's liquidity framework defines the asset classes that can be assessed locally as high quality and realisable within one month and between one month and three months. ALCO has to be satisfied that any asset which may be treated as liquid in accordance with the Group's liquid asset policy will remain liquid under the stress scenario being managed to.

Inflows from the utilisation of liquid assets within one month can generally only be based on confirmed withdrawable central bank deposits, gold or the sale or repo of government and quasi-government exposures generally restricted to those denominated in the sovereign's domestic currency. Covered bonds are also included but inflows assumed for these assets are capped.

Inflows after one month are also reflected for high quality non-financial and non-structured corporate bonds and equities within the most liquid indices.

Wholesale debt monitoring (unaudited)

Where wholesale debt term markets are accessed to raise funding, ALCO is required to ensure that there is no concentration of maturities of these term debts.

Sources of funding (unaudited)

The Group's primary sources of funding are customer current accounts and customer savings deposits payable on demand or at short notice. The Group also accesses wholesale funding markets by issuing senior unsecured debt securities (publicly and privately) and borrowing from the secured repo markets against high quality collateral, in order to supplement our customer deposits, change the currency mix and maturity profile, and maintain a presence in local wholesale markets.

The level of customer accounts continued to exceed the level of loans and advances to customers. The positive funding gap was predominantly deployed into liquid assets: cash and balances with central banks and financial investments, as required by the LFRF. Loans and other receivables due from banks continued to exceed deposits taken from banks. The Group remained a net unsecured lender to the banking sector.

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

Encumbered and unencumbered assets (unaudited)

The objective of this disclosure is to facilitate an understanding of available and unrestricted assets that could be used to support potential future funding and collateral needs. An asset is defined as encumbered, from a liquidity perspective, if it has been pledged as collateral against an existing liability, and as a result is no longer available to the bank to secure funding, satisfy collateral needs or be sold to reduce the funding requirement. An asset is therefore categorised as unencumbered if it has not been pledged against an existing liability.

The disclosure is not designed to identify assets which would be available to meet the claims of creditors or to predict assets that would be available to creditors in the event of a resolution or bankruptcy.

Analysis of on-balance sheet encumbered and unencumbered assets (unaudited)

The table below presents an analysis of on-balance sheet holdings only, and shows the amounts of balance sheet assets that are encumbered. The table therefore excludes any available off-balance sheet holdings received in respect of reverse repo, stock borrowing or derivatives.

At 31 December 2013	Encumbered			Unencumbered - cannot be pledged as collateral		Total
	Assets pledged as collateral	Readily realisable assets	Other realisable assets	Reverse repo/stock borrowing receivable & derivative assets	Cannot be pledged as collateral	
Cash and balances with banks	-	-	33,228	-	66	33,294
Placings with and advances to banks	213	-	112,564	-	18,586	131,363
Trading assets	3,758	20,077	8,161	-	-	31,996
Financial assets designated at fair value	-	-	-	-	6,987	6,987
Derivative financial instruments	-	-	-	6,646	-	6,646
Loans and advances to banks	-	-	-	-	-	-
Loans and advances to customers	-	-	586,007	-	233	586,240
Financial investments	20,908	189,441	964	-	71,532	282,845
Interest in associates	-	-	30	-	2,032	2,062
Investment properties	-	-	8,998	-	1,920	10,918
Premises, plant and equipment	-	-	20,510	-	490	21,000
Intangible assets	-	-	-	-	7,974	7,974
Other assets	-	4,184	14,675	-	3,546	22,405
Total assets	24,879	213,702	785,137	6,646	113,366	1,143,730

Cash collateral posted to satisfy margin requirements on derivatives, is reported as encumbered under trading assets within loans or advances to banks and loans and advances to customers.

Liquidity behaviouralisation (audited)

Liquidity behaviouralisation is applied to reflect our assessment of the expected period for which we are confident that we will have access to our liabilities, even under a severe liquidity stress scenario, and the expected period for which we must assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour. Liquidity behaviouralisation policy is reviewed and approved by ALCO.

Contingent liquidity risk (audited)

Operating entities provide customers with committed and standby facilities. These facilities increase the funding requirements of the Group when customers drawdown. The liquidity risk associated with the potential drawdown on non-cancellable committed facilities is factored into our stressed scenarios and limits are set for these facilities.

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

Contingency funding plan (unaudited)

A contingency funding plan ("LCP") is reviewed and approved by ALCO and the Board at least annually with an objective to ensure the Group can cope with a crisis by having practical and operational plan in place. The LCP states the options available to the Group for garnering liquidity and funding and an agreed course of action should there be an unexpected crisis. It is a real practical tool that can be used to manage liquidity during a crisis event. The LCP includes detailed action steps and properly assigned responsibilities. To serve as a guideline for the Crisis Management Team and its support team to evaluate the liquidity crisis situation and execute action steps during the crisis, the LCP consists of a sound Balance Sheet maturity analysis and spells out all potential funding sources with due consideration of their reliability, priority and the lead time during crisis. It also estimates liquidity shortfalls and liquid assets inflow from stress tests performed by the Bank under institution-specific, market-wide and combined stress scenarios.

Liquidity regulation (unaudited)

In December 2010, the Basel Committee published the 'International framework for liquidity risk measurement, standards and monitoring'. The framework comprises two liquidity metrics: the liquidity coverage ratio ("LCR") and the net stable funding ratio ("NSFR"). The ratios are subject to an observation period that began in 2011, and are expected to become established standards by 2015 and 2018, respectively.

In January 2013, the Basel Committee announced several changes to the calibration of the LCR which included reducing the outflow applied to non-operational non-financial corporate deposits from 75% to 40% and reducing the outflow applied to committed liquidity facilities from 100% to 30%. The Basel Committee has issued a consultation paper on a revised NSFR framework in January 2014.

The Hong Kong Monetary Authority ("HKMA") has also issued the consultation paper in July 2013 on the implementation of Basel III Liquidity Standards in Hong Kong. Two earlier consultation papers were issued in January and June 2012 respectively on the same subject.

Liquidity ratio under the Hong Kong Banking Ordinance (unaudited)

The Hong Kong Banking Ordinance also requires banks operating in Hong Kong to maintain a minimum liquidity ratio. The average liquidity ratio for the year, calculated in accordance with the Fourth Schedule of the Hong Kong Banking Ordinance, is as follows:

	2013	2012
The Bank and its subsidiaries designated by the HKMA	<u>34.9%</u>	<u>36.9%</u>

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

The below tables are an analysis of undiscounted cash flows on the Group's financial liabilities including future interest payments on the basis of their earliest possible contractual maturities.

The balances in the below tables will not agree with the balances in the balance sheet as the tables incorporate, on an undiscounted basis, all cash flows relating to principal and all future coupon payments (except for trading liabilities and trading derivatives). Also, loans commitments and financial guarantee contracts are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the "On demand" time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturities.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loans commitments expire without being drawn upon. The undiscounted cash flows potentially payable under loan commitments and financial guarantee are classified on the basis of the earliest date they can be called.

	Group					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2013						
Current, savings and other deposit accounts	601,609	185,495	36,641	3,334	1	827,080
Deposits from banks	3,868	7,958	-	-	-	11,826
Financial liabilities designated at fair value	2	-	-	-	487	489
Trading liabilities	62,117	-	-	-	-	62,117
Derivative financial instruments	4,525	204	311	301	-	5,341
Certificates of deposit and other debt securities in issue	-	24	3,973	4,663	-	8,660
Other financial liabilities	5,877	8,507	2,773	100	22	17,279
Subordinated liabilities	-	125	227	1,209	12,649	14,210
	677,998	202,313	43,925	9,607	13,159	947,002
Commitments	262,674	28,415	148	47	-	291,284
Financial guarantee contracts	15,104	88	2	-	-	15,194
	277,778	28,503	150	47	-	306,478
 At 31 December 2012						
Current, savings and other deposit accounts	567,310	168,224	34,416	937	-	770,887
Deposits from banks	3,369	16,501	3	-	-	19,873
Financial liabilities designated at fair value	1	-	-	-	463	464
Trading liabilities	59,853	-	-	-	-	59,853
Derivative financial instruments	2,763	122	232	965	50	4,132
Certificates of deposit and other debt securities in issue	-	34	7,404	3,952	-	11,390
Other financial liabilities	7,634	6,699	3,171	40	18	17,562
Subordinated liabilities	-	128	234	1,250	12,968	14,580
	640,930	191,708	45,460	7,144	13,499	898,741
Commitments	263,867	35,272	143	5	-	299,287
Financial guarantee contracts	12,481	64	-	-	-	12,545
	276,348	35,336	143	5	-	311,832

Management Discussion and Analysis (continued)

Risk Management (continued)

(b) Liquidity and funding risk (continued)

	Bank					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2013						
Current, savings and other deposit accounts	585,612	168,172	21,183	59	-	775,026
Deposits from banks	3,868	6,144	-	-	-	10,012
Financial liabilities designated at fair value	-	-	-	-	-	-
Trading liabilities	29,914	-	-	-	-	29,914
Derivative financial instruments	3,766	204	311	301	-	4,582
Certificates of deposit and other debt securities in issue	-	24	3,973	4,663	-	8,660
Amounts due to subsidiaries	3,400	10,926	-	-	-	14,326
Other financial liabilities	5,806	5,714	1,833	100	22	13,475
Subordinated liabilities	-	125	227	1,209	12,649	14,210
	632,366	191,309	27,527	6,332	12,671	870,205
Commitments	231,588	28,414	148	47	-	260,197
Financial guarantee contracts	11,666	78	2	-	-	11,746
	243,254	28,492	150	47	-	271,943
At 31 December 2012						
Current, savings and other deposit accounts	553,445	157,362	20,079	188	-	731,074
Deposits from banks	3,289	10,686	3	-	-	13,978
Financial liabilities designated at fair value	-	-	-	-	-	-
Trading liabilities	27,776	-	-	-	-	27,776
Derivative financial instruments	2,807	87	149	446	50	3,539
Certificates of deposit and other debt securities in issue	-	34	7,404	3,952	-	11,390
Amounts due to subsidiaries	5,441	9,840	-	-	-	15,281
Other financial liabilities	7,327	5,461	1,289	40	19	14,136
Subordinated liabilities	-	128	234	1,250	12,968	14,580
	600,085	183,598	29,158	5,876	13,037	831,754
Commitments	228,488	35,243	143	5	-	263,879
Financial guarantee contracts	10,415	64	-	-	-	10,479
	238,903	35,307	143	5	-	274,358

Management Discussion and Analysis (continued)

Risk Management (continued)

(c) Market risk (audited)

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 monitors market risk exposures separately for trading and non-trading portfolios. Trading portfolios include those positions arising from market-making, customer-related business, principal position-taking and strategic foreign exchange. 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 ("RMC"). 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 Asset and Liability Management Committee ("ALCO").

Value at risk ("VAR") (audited)

One of the principal tools used by the Group to monitor and limit market risk exposure is VAR.

VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence. Historical simulation uses scenarios derived from historical market rates and takes account of the relationships between different markets and rates, for example, interest rates and foreign exchange rates. Movements in market prices are calculated by reference to market data from the last two years. The assumed holding period is a 1-day period with a 99 per cent level of confidence, reflecting the way the risk positions are managed.

VAR is calculated daily. The Group validates the accuracy of its VAR models by back-testing the actual daily profit and loss results which include both end of day market movements and intra-day trading outcomes, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the Group would expect to see losses in excess of VAR only one per cent of the time over a 1-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

Apart from the standard 1-day VAR mentioned above, the Group has introduced stressed VAR since the start of 2012 according to the Basel 2.5 requirement. Stressed VAR is the measure of VAR using a continuous one-year historical period of severe stress for the trading portfolio, assuming a 10-day holding period with a 99 per cent level of confidence.

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.

Management Discussion and Analysis (continued)

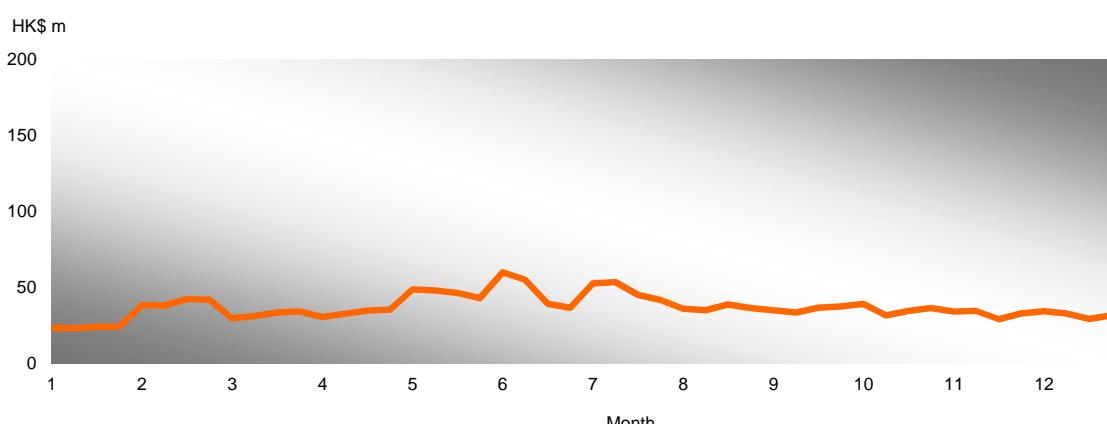
Risk Management (continued)

(c) Market risk (continued)

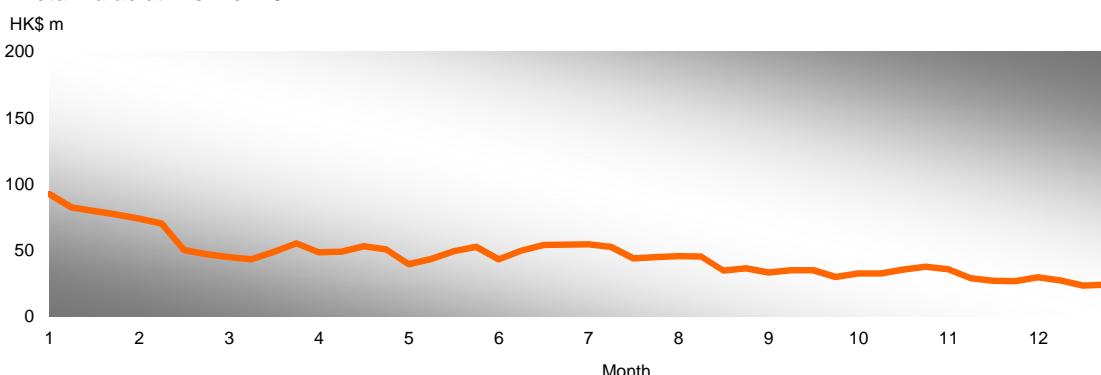
The Group's VAR, both total and trading positions, and stressed VAR for trading positions during 2013 and 2012 are shown in the tables below.

	At 31 December 2013	Minimum during the year	Maximum during the year	Average for the year
VAR				
Total (trading and non-trading)	29	22	60	37
Total trading	4	4	17	7
Foreign exchange trading	3	2	15	6
Interest rate trading	3	3	9	4
Stressed VAR				
Total trading	27	14	80	33
Foreign exchange trading	13	5	48	17
Interest rate trading	37	16	82	40
	At 31 December 2012	Minimum during the year	Maximum during the year	Average for the year
VAR				
Total (trading and non-trading)	23	23	92	46
Total trading	4	4	23	10
Foreign exchange trading	4	2	9	5
Interest rate trading	4	4	23	9
Stressed VAR				
Total trading	30	18	104	45
Foreign exchange trading	12	5	33	16
Interest rate trading	27	13	106	42

Total Value at Risk for 2013



Total Value at Risk for 2012



Management Discussion and Analysis (continued)

Risk Management (continued)

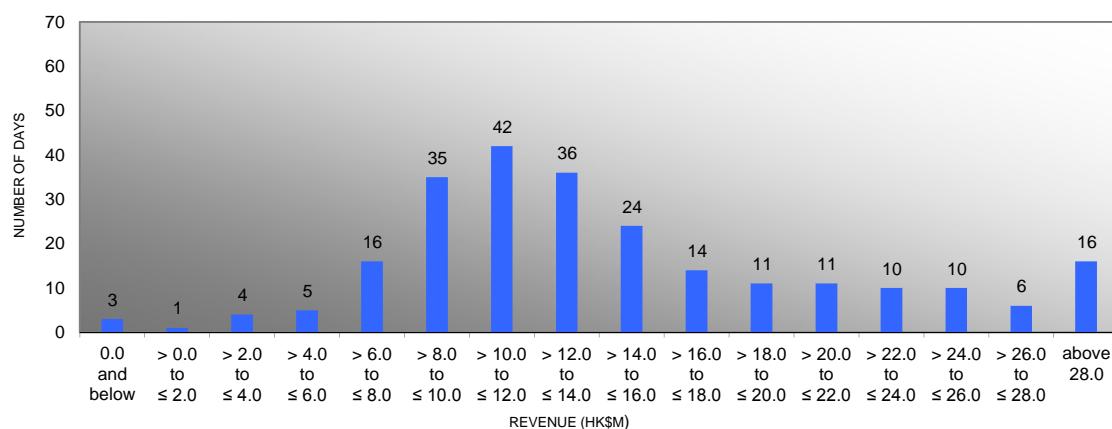
(c) Market risk (continued)

Daily distribution of market risk revenues (unaudited)

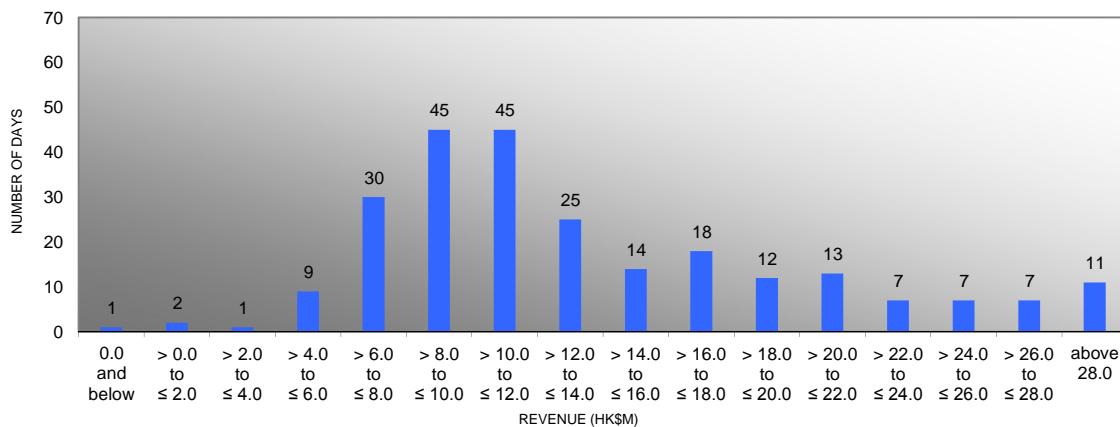
The average daily revenue earned from market risk-related treasury activities in 2013, including non-trading book net interest income and funding related to trading positions, was HK\$15 million (2012: HK\$14 million). The standard deviation of these daily revenues was HK\$8 million, no change with 2012.

An analysis of the frequency distribution of daily revenue shows that out of 244 trading days in 2013, losses were recorded on 3 days (2012: 1 day) and the maximum daily loss was HK\$10 million (2012: HK\$3 million). The most frequent result was a daily revenue of between HK\$6 million and HK\$8 million, with 167 occurrences (2012: 177 occurrences). The highest daily revenue was HK\$49 million (2012: HK\$69 million).

DAILY DISTRIBUTION OF MARKET RISK REVENUES FOR 2013



DAILY DISTRIBUTION OF MARKET RISK REVENUES FOR 2012



Management Discussion and Analysis (continued)

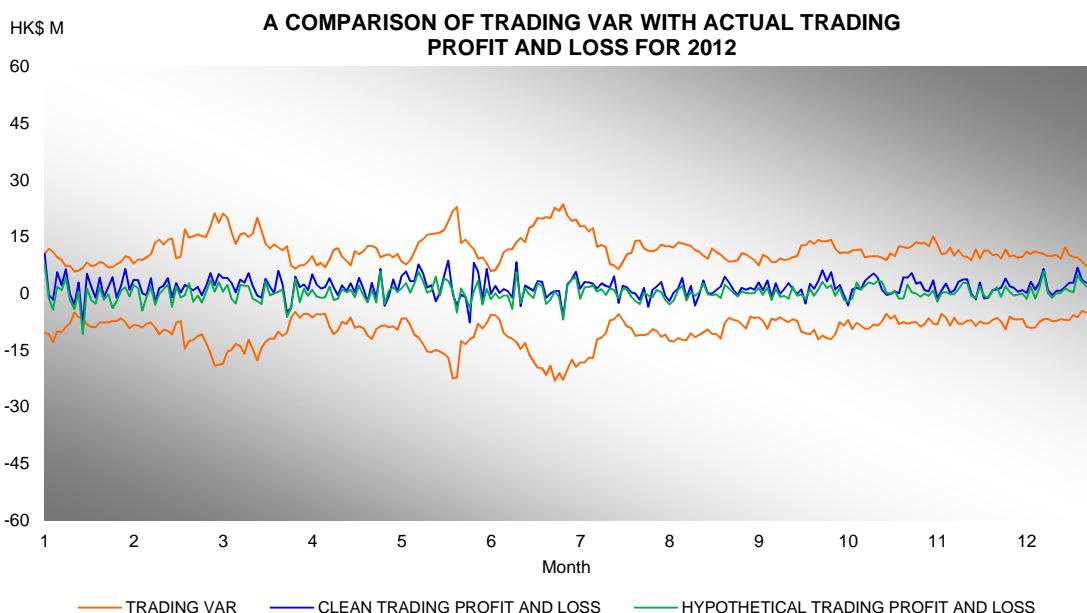
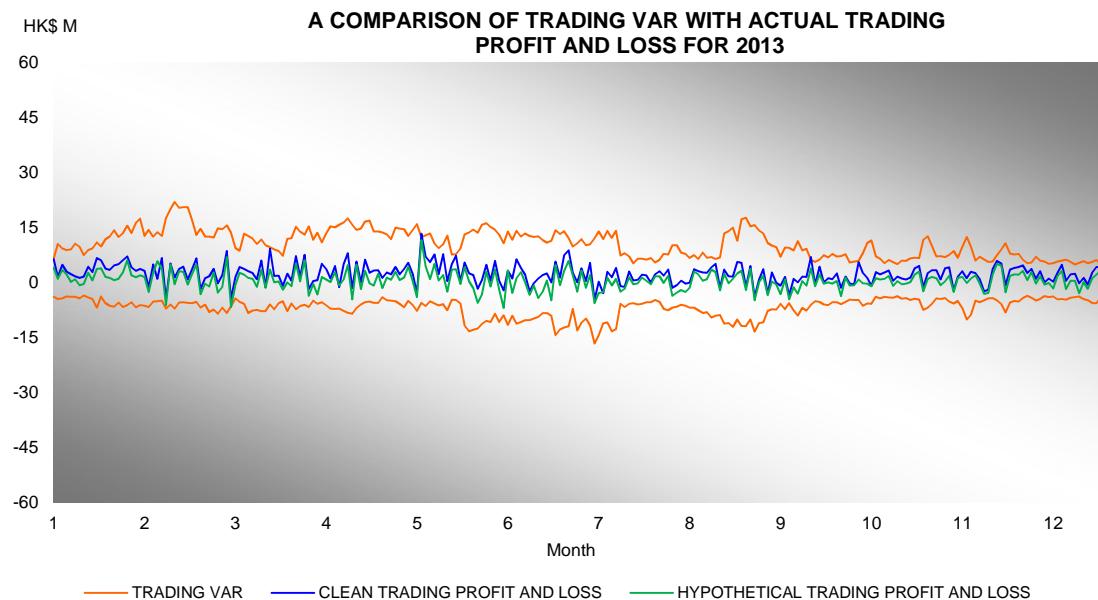
Risk Management (continued)

(c) Market risk (continued)

Back-testing of the Trading VAR model for interest rate and foreign exchange uses both clean and hypothetical profits and losses from trading operations and compares these to total trading VAR, foreign exchange trading and interest rate trading level VAR on a daily basis. Clean profits and losses include both end of day market movements and intra-day trading outcomes, while hypothetical profits and losses include only end of day market movements.

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 2013 and 2012 are shown in the graphs below.



Management Discussion and Analysis (continued)

Risk Management (continued)

(c) Market risk (continued)

Interest rate exposure (audited)

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 RMC and under the monitoring of both ALCO and RMC.

Trading (audited)

The Group's control of market risk is based on restricting individual operations to trading within VAR and underlying sensitivity limits including foreign exchange position limits, present value of a basis point limits and option limits, and a list of permissible instruments authorised by the RMC, 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 (audited)

Market risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes.

Analysis of this risk is complicated by having to make assumptions on optionality in certain product areas, for example, mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example, current accounts. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to 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 monitors all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits established by the RMC.

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 2014 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 2014.

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 ending 31 December 2014 by HK\$2,737 million for 100 basis points case and by HK\$1,961 million for 25 basis points case, while such a series of incremental parallel falls in all-in yield curves would decrease planned net interest income by HK\$2,678 million for 100 basis points case and by HK\$2,194 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and take into account the change in pricing of retail products relative to change in market interest rates.

Management Discussion and Analysis (continued)

Risk Management (continued)

(c) Market risk (continued)

Projected Net Interest Income (audited)

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
Change in 2014 projected net interest income				
- HKD	1,432	(1,498)	963	(1,259)
- US\$	598	(471)	427	(403)
- other	707	(709)	571	(532)
Total	<u><u>2,737</u></u>	<u><u>(2,678)</u></u>	<u><u>1,961</u></u>	<u><u>(2,194)</u></u>
Change in 2013 projected net interest income (restated)				
- HKD	912	(970)	681	(845)
- US\$	511	(392)	366	(329)
- other	427	(390)	313	(286)
Total	<u><u>1,850</u></u>	<u><u>(1,752)</u></u>	<u><u>1,360</u></u>	<u><u>(1,460)</u></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.

Sensitivity of reserves (audited)

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 dates indicated below and the maximum and minimum month figures during the year then ended:

	At 31 December 2013	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(855)	(987)	(855)
As a percentage of shareholders' funds at 31 December 2013 (%)	(0.8)	(0.9)	(0.8)
- 100 basis points parallel move in all-in yield curves	350	377	314
As a percentage of shareholders' funds at 31 December 2013 (%)	0.3	0.3	0.3
	At 31 December 2012	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(988)	(1,027)	(863)
As a percentage of shareholders' funds at 31 December 2012 (%)	(1.1)	(1.1)	(0.9)
- 100 basis points parallel move in all-in yield curves	381	412	226
As a percentage of shareholders' funds at 31 December 2012 (%)	0.4	0.4	0.2

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.

Management Discussion and Analysis (continued)

Risk Management (continued)

(c) Market risk (continued)

Foreign exchange exposure (audited)

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 RMC. The net options position is calculated on the basis of delta-weighted positions of all foreign exchange options contracts.

The Group's gross structural foreign exchange exposure is represented by the net asset value of the Group's foreign currency investments in subsidiaries, branches and associates, and the fair value of the Group's long-term foreign currency equity investments. The Group's structural foreign currency exposures are managed by the Group's ALCO with the primary objective of ensuring, where practical, that the Group's and the Bank's capital ratios are protected from the effect of changes in exchange rates. The details of net structural and non-structural foreign currency positions of the Group are set out in supplementary note 14 to the financial statements.

Equities exposure (audited)

The Group's equities exposures in 2013 and 2012 are mainly long-term equity investments which are reported as "Financial investments" set out in note 32 to the financial statements. Equities held for trading purpose are included under "Trading assets" set out in note 28 to the financial statements. These are subject to trading limit and risk management control procedures and other market risk regime.

(d) Insurance risk (audited)

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 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 activities.

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, taking into account where appropriate local market conditions and regulatory requirements apply.

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, incorporated with certain degree of randomness, and the actual number and size 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, risk profile, diversification, asset/liability matching, liquidity and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Investment Committee and Risk Management Committee of the Group's insurance subsidiaries review and approve the investment policy including asset allocation, investment guidelines and limits on a periodic basis, while the Asset and Liability Management Committee provides oversight of the asset/liability management process.

The Group establishes the investment policy for each major insurance product category according to specific product requirements and local regulatory requirement. The investment policy defines the asset allocations and restrictions with an aim to achieve the target investment return in the long term. 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. Actual results may deviate from the estimate and assumption and could impact the Group's ability to achieve its asset/liability management goals and objectives.

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

The following table shows the composition of assets and liabilities for each major insurance product category.

Balance sheet of insurance subsidiaries by type of contract

	Life linked contracts ¹	Life non-linked contracts ²	Non-life insurance ³	Other assets ⁴	Total ⁵
2013					
Financial assets:					
- financial assets designated at fair value	233	6,754	-	-	6,987
- derivatives	-	3	-	-	3
- financial investments	-	66,672	-	4,853	71,525
- other financial assets	13	7,963	-	2,129	10,105
Total financial assets	246	81,392	-	6,982	88,620
Reinsurance assets	-	1,465	-	-	1,465
Present value of in-force long-term insurance contracts	-	-	-	7,198	7,198
Other assets	-	4,893	-	758	5,651
Total assets	246	87,750	-	14,938	102,934
Liabilities under investment contracts designated at fair value					
Liabilities under insurance contracts	155	335	-	-	490
Deferred tax	88	85,756	-	-	85,844
Other liabilities	-	-	-	1,239	1,239
Total liabilities	243	86,091	-	1,793	88,127
Shareholders' equity	-	-	-	14,807	14,807
Total liabilities and shareholders' equity	243	86,091	-	16,600	102,934
2012					
Financial assets:					
- financial assets designated at fair value	224	8,119	-	-	8,343
- derivatives	-	171	-	-	171
- financial investments	-	64,297	-	3,350	67,647
- other financial assets	11	7,878	49	2,105	10,043
Total financial assets	235	80,465	49	5,455	86,204
Reinsurance assets	-	414	-	16	430
Present value of in-force long-term insurance contracts	-	-	-	6,003	6,003
Other assets	-	889	-	2,333	3,222
Total assets	235	81,768	49	13,807	95,859
Liabilities under investment contracts designated at fair value					
Liabilities under insurance contracts	141	323	-	-	464
Deferred tax	91	81,579	-	-	81,670
Other liabilities	-	-	-	991	991
Total liabilities	232	81,902	-	1,618	83,752
Shareholders' equity	-	-	-	12,107	12,107
Total liabilities and shareholders' equity	232	81,902	-	13,725	95,859

1 Comprise life linked insurance contracts and linked investment contracts

2 Comprise life non-linked insurance contracts and non-linked investment contracts

3 Comprise non-life insurance contracts

4 Comprise shareholder assets

5 Total assets of life insurance subsidiaries at 31 December 2013 amounted to HK\$102,934 million (31 December 2012: HK\$95,810 million). Total assets of non-life insurance subsidiary at 31 December 2013 is nil (31 December 2012: HK\$49 million).

Management Discussion and Analysis (continued)

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. These reinsurance agreements transfer part of the risk and limit the exposure from each life insured. The amount of each risk retained depends on the Group's evaluation of the specific risk, subject in certain circumstances, to maximum limits based on characteristics of coverage. Under the terms of the reinsurance agreements, the reinsurer agrees to reimburse the ceded amount in the event the claim is paid. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum-at-risk so that it falls within specified insurance risk appetite. The Group also utilises reinsurance to manage the risk arising from guarantees provided to the policyholders under the non-linked traditional non-participating insurance product. In addition, the Group uses reinsurance agreements with non-affiliated reinsurers to manage its exposure to losses resulting from certain catastrophes. However, the Group remains liable to its policyholders with respect to ceded insurance if any reinsurer fails to meet the obligations it assumes.

Nature of risks covered

The following gives an assessment of the nature of risks inherent in the Group's main products.

(i) Long-term 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 insurance products with a savings element, guaranteed surrender and maturity benefit are usually provided. Most of the Group's non-linked products include a discretionary participating feature which allows policyholders to participate in the profits of the life fund. These plans offer a discretionary annual bonus in the form of dividend payable to the policyholders on each policy anniversary date.

In particular, a major block of non-linked products provides policyholders with an option to receive guaranteed and discretionary bonus in form of annually bonus during a predefined period before maturity.

The principles for the distribution of profits among the policyholders are:

- (i) to recognise the financial condition of the Group's insurance subsidiaries;
- (ii) to take into consideration the reasonable expectation of policyholders and to provide a smooth and stable return over the long term; and
- (iii) to balance the interests between the shareholders and policyholders.

Investment risks are managed through matching assets and liabilities. Investment strategy is to predominantly invest in high quality bonds with some portion in growth assets for return enhancement. Mortality risks are managed through reinsurance and proper underwriting.

The Group has contractual discretion on the dividend declared. In practice the Group considers policyholders' reasonable expectations when declaring dividend levels. It is the Group's intention to maintain a smooth and stable dividend scale which is set based on the long-term expected investment return. An annual review is performed to confirm whether the current dividend scale is supportable taking into account the actual and expected experiences on investments return, policy persistency, claims and expenses.

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

(ii) Long-term insurance contracts - linked products

The Group writes linked life insurance policies, which 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 will be deducted from the funds accumulated.

Although the policyholders bear the market risk on linked products, the Group assumes reputational risk for any undue market risk taken by the policyholders. Consequently, it is in the Group's interest to ensure that the policyholders' exposure to market risk is consistent with any market risk information that the Group has communicated to the policyholders.

Claims and expenses experiences are reviewed regularly to ensure current charges are sufficient to cover the costs.

(iii) Long-term investment contracts - non-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. The accumulated fund balance will be payable to scheme members upon retirement or termination of employment. The Group provides an investment return guarantee on these funds. The guaranteed 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) Long-term investment contracts - 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. The accumulated fund balance will be payable to scheme members upon retirement or termination of employment. Although the scheme members bear the market risk on linked products, the Group assumes reputational risk for any undue market risk taken by the scheme members. Consequently, it is in the Group interest to ensure that the scheme members' exposure to market risk is consistent with any market risk information that the Group has communicated to the scheme members.

Management Discussion and Analysis (continued)

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, pricing guidelines, 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, 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 acquired immunodeficiency syndrome ("AIDS"), severe acute respiratory syndrome ("SARS") or a human form of avian flu) or widespread changes in lifestyle, 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, 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 an appropriate 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 45 to the financial statements. By contrast for analysis of non-life insurance risk, written premiums represent an appropriate measure of risk exposure as shown in the following table.

Analysis of non-life insurance risk - net written insurance premiums

	2013	2012
Accident and health	- 46	46
Fire and other damage	- 71	71
Motor	- 11	11
Liability	- 35	35
Marine, aviation and transport	- 10	10
Other	- 2	2
	<hr/> <hr/> - 175	<hr/> <hr/> 175

Management Discussion and Analysis (continued)

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 balance sheet dates by type of liability, and provides a view of the exposure to financial risk:

Financial assets held by insurance operations

	Group				
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	Total
2013					
Financial assets designated at fair value:					
- debt securities	-	812	-	-	812
- equity securities	233	5,942	-	-	6,175
	233	6,754	-	-	6,987
Financial investments					
Held-to-maturity:					
- debt securities	-	66,673	-	4,832	71,505
	-	66,673	-	4,832	71,505
Available-for-sale:					
- debt securities	-	-	-	-	-
- equity securities	-	-	-	20	20
	-	-	-	20	20
Derivatives	-	3	-	-	3
Other financial assets	13	7,963	-	2,129	10,105
	246	81,393	-	6,981	88,620

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

				Group		
		Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	Total
2012						
Financial assets designated at fair value:						
- debt securities		-	4,047	-	-	4,047
- equity securities		224	4,072	-	-	4,296
		<u>224</u>	<u>8,119</u>	<u>-</u>	<u>-</u>	<u>8,343</u>
Financial investments						
Held-to-maturity:						
- debt securities		-	64,297	-	3,334	67,631
		<u>-</u>	<u>64,297</u>	<u>-</u>	<u>3,334</u>	<u>67,631</u>
Available-for-sale:						
- debt securities		-	-	-	-	-
- equity securities		-	-	-	16	16
		<u>-</u>	<u>-</u>	<u>-</u>	<u>16</u>	<u>16</u>
Derivatives						
Other financial assets		-	171	-	-	171
		<u>11</u>	<u>7,878</u>	<u>49</u>	<u>2,105</u>	<u>10,043</u>
		<u>235</u>	<u>80,465</u>	<u>49</u>	<u>5,455</u>	<u>86,204</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 0.3% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2013 (2012: 0.3%). The table also shows that approximately 81.6% of financial assets was invested in debt securities at 31 December 2013 (2012: 83.1%) and 7.0% (2012: 5.0%) invested in equity securities.

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 exchange rates. Each of these categories is discussed further below.

Interest rate risk

The insurance subsidiaries of the Group's exposure to interest rate risk because there is a chance that the yields earned on its debt securities holding are lower than the investment returns implied by the guarantees payable to policyholders. The held-to-maturity debt securities account for a significant portion of the debt securities holding which is managed to match expected liability payments. The Group monitors this exposure through periodic reviews of its asset and liability position. 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 manage 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.

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

Interest rate risk (continued)

An immediate and permanent movement in interest yield curves as at 31 December 2013 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the aggregated profit after tax for the year and shareholders' equity at that date:

	2013			2012		
	Impact on profit after tax for the year	Impact on shareholders' equity		Impact on profit after tax for the year	Impact on shareholders' equity	
+ 100 basis points shift in yield curves	383	383		377	377	
- 100 basis points shift in yield curves	(450)	(450)		(475)	(475)	

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 effects are calculated taking into account the sharing of investment returns with policyholders through the discretionary participating feature. Other than that, they do not incorporate other actions that could be taken by management to mitigate the effect of the interest rate movements, nor do they take into account any resultant changes in policyholder behaviour.

Equity price risk

The portfolio of marketable securities (including collective investment schemes) backing non-linked insurance contracts and shareholders' fund, which the insurance subsidiaries of the Group carry 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 tactic asset allocation or hedging strategy and sharing the risk with policyholders through the discretionary participation feature. The Group's objective is to earn competitive returns by investing in a diversified portfolio of high quality and liquid securities. Portfolio characteristics are analysed regularly and equity price risk is regularly reviewed. The Group's investment portfolios are diversified across countries and 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 after tax for the year and shareholders' equity of a reasonably possible 10 per cent variance in equity prices:

	2013			2012		
	Impact on profit after tax for the year	Impact on shareholders' equity		Impact on profit after tax for the year	Impact on shareholders' equity	
10 per cent increase in equity prices	162	162		120	120	
10 per cent decrease in equity prices	(144)	(144)		(84)	(84)	

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. The impact is estimated taking into account the sharing of risk through the discretionary participation feature.

Foreign currency risk

The assets and liabilities of the insurance subsidiaries of the Group are mainly denominated in United States dollar ("USD") and Hong Kong dollar ("HKD"). 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 foreign exchange forward contracts to manage its foreign currency risk. Most of the foreign exchange forward contracts have maturities of less than one year after the balance sheet date.

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

Credit risk

The insurance subsidiaries of the Group's portfolio of debt 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 relative competitive returns by investing in a diversified portfolio of securities. Management has a credit policy in place. Limits are established to manage credit quality and concentration risk. The following table presents the analysis of treasury bills, other eligible bills and debt securities within the Group's insurance operations.

Treasury bills, other eligible bills and debt securities in insurance operations

	Neither past due nor impaired			Past due		Impairment allowances	Total
	Strong	Medium	Sub-standard	not impaired	Impaired		
2013							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	569	243	-	-	-	-	812
	569	243	-	-	-	-	812
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	60,285	6,388	-	-	-	-	66,673
	60,285	6,388	-	-	-	-	66,673
Supporting shareholders funds							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-	-
	-	-	-	-	-	-	-
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	4,762	70	-	-	-	-	4,832
	4,762	70	-	-	-	-	4,832
Total							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	569	243	-	-	-	-	812
	569	243	-	-	-	-	812
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	65,047	6,458	-	-	-	-	71,505
	65,047	6,458	-	-	-	-	71,505

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub- standard				
2012							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	3,905	142	-	-	-	-	4,047
	<u>3,905</u>	<u>142</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,047</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	57,545	6,752	-	-	-	-	64,297
	<u>57,545</u>	<u>6,752</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>64,297</u>
Supporting shareholders funds							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	-	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	3,264	70	-	-	-	-	3,334
	<u>3,264</u>	<u>70</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>3,334</u>
Total							
Financial assets designated at fair value:							
- treasury and other eligible bills	-	-	-	-	-	-	-
- debt securities	3,905	142	-	-	-	-	4,047
	<u>3,905</u>	<u>142</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,047</u>
Financial investments:							
- treasury and other similar bills	-	-	-	-	-	-	-
- debt securities	60,809	6,822	-	-	-	-	67,631
	<u>60,809</u>	<u>6,822</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>67,631</u>

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

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

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired			Past due not impaired		Impairment allowances	Total
	Strong	Medium	Sub- standard	Impaired	-		
2013							
Linked insurance contracts	-	-	-	-	-	-	-
Non-linked insurance contracts	1,446	-	-	-	-	-	1,446
Total	<u>1,446</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,446</u>
Reinsurance Debtors	7	-	-	12	-	-	19
2012							
Linked insurance contracts	-	-	-	-	-	-	-
Non-linked insurance contracts	414	-	-	-	-	-	414
Total	<u>414</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>414</u>
Reinsurance Debtors	4	-	-	12	-	-	16

Management Discussion and Analysis (continued)

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 balance sheet dates:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year	Over 1 year but within 5 years	Over 5 years but within 15 years	Over 15 years	Total
2013					
Non-life insurance	-	-	-	-	-
Life insurance (non-linked)	9,091	32,326	81,196	57,573	180,186
Life insurance (linked)	11	42	116	618	787
	9,102	32,368	81,312	58,191	180,973
2012					
Non-life insurance	-	-	-	-	-
Life insurance (non-linked)	9,858	35,444	71,093	48,424	164,819
Life insurance (linked)	12	49	132	853	1,046
	9,870	35,493	71,225	49,277	165,865

Remaining contractual maturity of investment contract liabilities

	Liabilities under investment contracts by insurance underwriting subsidiaries			
	Linked investment contracts	Non-linked investment contracts	Investment contracts with DPF	Total
2013				
Remaining contractual maturity:				
- due within 1 year	2	-	-	2
- due over 1 year but within 5 years	-	-	-	-
- due over 5 years but within 10 years	-	-	-	-
- due over 10 years	-	-	-	-
- undated	153	335	-	488
	155	335	-	490
2012				
Remaining contractual maturity:				
- due within 1 year	1	-	-	1
- due over 1 year but within 5 years	-	-	-	-
- due over 5 years but within 10 years	-	-	-	-
- due over 10 years	-	-	-	-
- undated	140	323	-	463
	141	323	-	464

Management Discussion and Analysis (continued)

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 2013 was HK\$7,198 million (31 December 2012: HK\$6,003 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at balance sheet dates 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 at balance sheet date of reasonably possible changes in the main economic and business assumptions:

	2013	2012
+ 100 basis points shift in risk-free rate	496	474
- 100 basis points shift in risk-free rate	(576)	(593)

The effects on PVIF shown 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 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 into account the 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 is as follows:

	Impact on 2013 results		Impact on 2012 results	
	Profit for the year	Net assets	Profit for the year	Net assets
10 per cent increase in mortality and/or morbidity rates	(62)	(62)	(86)	(86)
10 per cent decrease in mortality and/or morbidity rates	61	61	86	86
50 per cent increase in lapse rates	(42)	(42)	91	91
50 per cent decrease in lapse rates	79	79	(59)	(59)
10 per cent increase in expense rates	(95)	(95)	(84)	(84)
10 per cent decrease in expense rates	95	95	84	84

Process used to determine assumptions for long-term insurance contracts

The process used to determine the assumptions is intended to result in stable and prudent estimates of future outcome. This is achieved by adopting relatively conservative assumptions which can withstand a reasonable range of fluctuation of actual experience. Annual review of the relevant experience is performed to assess the adequacy of margin between the assumptions adopted and the best estimate of future outcome. The assumptions that are considered include the probability of claims and investment returns.

For non-linked life business, the policy reserve is generally calculated on a modified net premium basis. The net premium is the level of premium payable over the premium payment period whose discounted value at the outset of the policy would be sufficient to exactly cover the discounted value of the original guaranteed benefits at maturity or at death if earlier. The net premium is then modified to allow for deferral of acquisition costs. The policy reserve is then calculated by subtracting the present value of future modified net premiums from the present value of the benefits guaranteed at maturity or death up to the balance sheet date. Negative provisions would not be allowed. The modified net premium basis makes no allowance for voluntary discontinuance by policyholders as this would generally result in a reduced level of policy reserve.

For linked life business, the policy reserve is generally determined as the total account balance of all in-force policies with an additional provision for the unexpired insurance risk.

Assumptions

The principal assumptions underlying the calculation of the long-term insurance business provision are:

(i) Mortality

A base mortality table which is most appropriate for each type of contract is selected. A loading is generally added as a provision for adverse deviation. An annual investigation is performed to ascertain the appropriateness with the Group's insurance subsidiary's actual experience.

Management Discussion and Analysis (continued)

Risk Management (continued)

(d) Insurance risk (continued)

(ii) Morbidity

The morbidity incidence rates, which mainly cover major illness and disability, are generally derived from the reinsurance costs which also form the pricing basis. A loading is generally added as a provision for adverse deviation. An annual investigation is performed to ascertain the appropriateness with the Group's insurance subsidiary's actual experience.

(iii) Discount rates

Rate of interest

	2013	2012
Policies denominated in HKD	3%	3%
Policies denominated in USD	4%	4%

Under the modified net premium method, the long-term business provision is sensitive to the interest rate used when discounting.

Sensitivity to changes in variables

The Group's insurance company re-runs its valuation models on various bases. An analysis of sensitivity around various scenarios provides an insight to the key risks which the Group's insurance company is exposed to. The table presented below demonstrates the sensitivity of insured liability estimates to particular movements in assumptions used in the estimation process. Certain variables can be expected to impact on life assurance liabilities more than others, and consequently a greater degree of sensitivity to these variables may be expected.

Impact on reported profit to changes in key variable

	Change in variable %	Change in liabilities	
		2013	2012
Base run		77,897	74,939
Discount rate	+1	(1,430)	(1,588)
Discount rate	-1	5,335	5,060
Mortality/Morbidity	+10	30	50
Mortality/Morbidity	-10	(19)	(44)

The analysis above has been prepared for a change in variable with all other assumptions remaining constant and ignores changes in values of the related assets.

For the sensitivity in discount rate, an absolute +/-1% of the discount rate is used. For the mortality/ morbidity sensitivity, a relative +/-10% (i.e. multiply the assumption by 110% or 90%) is used.

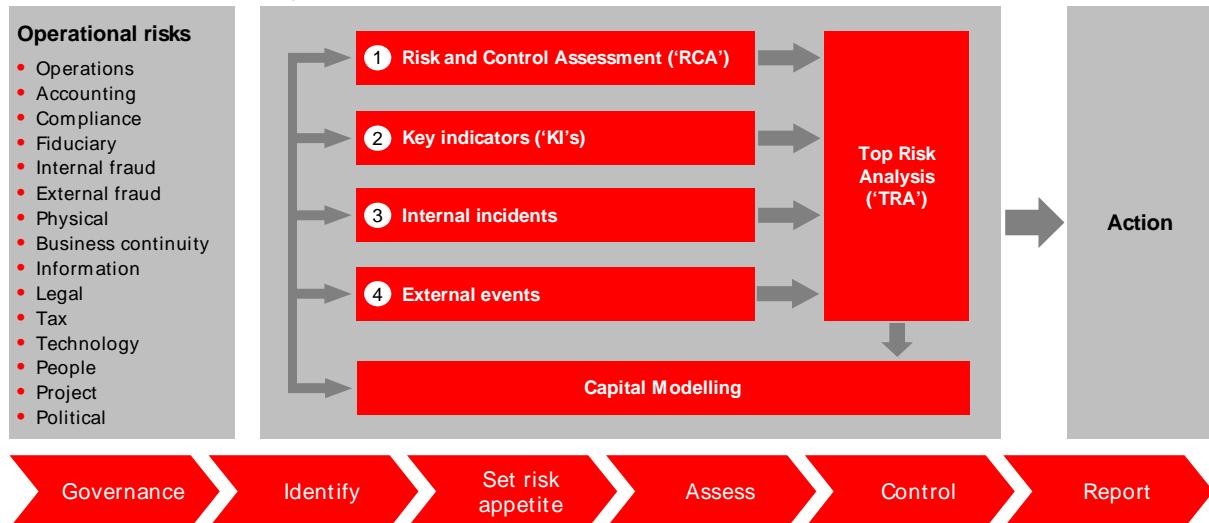
Management Discussion and Analysis (continued)

Risk Management (continued)

(e) Operational risk

Operational risk management framework (audited)

The Operational Risk function and the operational risk management framework ("ORMF") assist business management in discharging their responsibilities. The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control across the Group.



- RCAs are used to inform the evaluation of the effectiveness of controls over top risks.
- KIs are used to help monitor the risks and controls.
- TRAs (scenarios) provide management with a quantified view of our top and emerging operational risks.
- Internal incidents are used to forecast typical losses.
- External sources are used to inform the assessment of extreme TRAs.

Articulating our risk appetite for material operational risks helps business understand the level of risk our organisation is willing to accept. Monitoring operational risk exposure against risk appetite on a regular basis and implementing our risk acceptance process drives risk awareness in a more forward-looking manner. It assists management in determining whether further action is required.

In addition, an enhanced Top Risk Analysis process will be implemented across material legal entities of the Group to improve the quantification and management of material risks through scenario analysis.

The incidence of regulatory proceedings and other adversarial proceedings against financial service firms is increasing. Proposed changes relating to capital and liquidity requirements, remuneration and/or taxes could increase our cost of doing business, reducing future profitability. Various regulators and competition authorities around the world are also investigating and reviewing certain past submissions made by panel banks and the process for making submissions in connection with the setting of benchmark interest and foreign exchange rates. In response, we have undertaken a number of initiatives which seek to address the issues identified, including enhancing our governance and oversight, increasing our compliance function resource, emphasising the Group's Values and implementing new global standards.

Other featured operational risks (unaudited)

- Fraud risks: the threat of fraud perpetrated by or against our customers, especially in retail and commercial banking, may increase during adverse economic conditions. We have increased monitoring, root cause analysis and review of internal controls to enhance our defences against external attacks and reduce the level of loss in these areas. In addition, Security and Fraud Risk is working closely with the businesses to continually assess these threats as they evolve and adapt our controls to mitigate these risks.
- Information security: the security of our information and technology infrastructure is crucial for maintaining our banking applications and processes while protecting our customers and the Hang Seng brand. A failure of our defences against such attacks could result in financial loss, loss of customer data and other sensitive information which could undermine both our reputation and our ability to retain the trust of our customers.

Management Discussion and Analysis (continued)

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

Capital Management

(audited)

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 of different level of equity capital on shareholder returns and seeks to maintain a prudent balance between advantages and flexibility provided by a strong capital position and higher returns on equity through greater leverage.

An annual Group capital plan is prepared and approved by the Board with the objectives of maintaining an optimal amount of capital and a suitable mix between different components of capital. The Group manages its own capital within the context of the approved annual Group capital plan, which determines level of risk-weighted asset ("RWA") growth as well as the optimal amount and components 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 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 and profit. 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 collectively impairment allowances and regulatory reserve for general banking risks as allowed under Banking (Capital) Rules.

Externally imposed capital requirements

(audited)

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

The Group uses the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. For market risk, the Group uses an internal models approach to calculate its general market risk for the risk categories of interest rate and foreign exchange (including gold) exposures and the standardised (market risk) approach for calculating other market risk positions. For operational risk, the Group uses the standardised (operational risk) approach to calculate its operational risk.

During the year, the Group has complied with all of the externally imposed capital requirements by the HKMA.

Basel III

(unaudited)

In December 2010, the Basel Committee on Banking Supervision ("BCBS") issued two documents: A global regulatory framework for more resilient banks and banking systems and International framework for liquidity risk measurement, standards and monitoring, which together are commonly referred to as "Basel III". In June 2011, the BCBS issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades.

The Basel III rules set out the minimum capital requirements, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019 with ultimate CET1 capital ratio and capital conservation buffer minimum requirements at 4.5% and 2.5% respectively. Any additional countercyclical capital buffer requirements will also be phased in, starting in 2016 to a maximum level of 2.5% effective on 1 January 2019, although individual jurisdictions may choose to implement larger countercyclical capital buffers. In addition to the criteria detailed in the Basel III proposals, the BCBS issued further minimum requirements in January 2011 to ensure that all classes of capital instruments are able to absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The capital treatment of instruments issued prior to this date that meet the grandfathering conditions will be phased out over a 10-year period commencing on 1 January 2013.

Management Discussion and Analysis (continued)

Capital Management (continued)

The Banking (Capital) (Amendment) Rules 2012, effective on 1 January 2013, signified the first phase of Basel III requirements in Hong Kong. The changes in minimum capital ratio requirements are phased in from 1 January 2013 to 1 January 2019, while the capital treatment for counterparty credit risk is effective from 1 January 2013.

Leverage ratio (unaudited)

The leverage ratio was introduced into the Basel III framework as a non-risk-based backstop limit, to supplement risk-based capital requirements. It aims to constrain the build-up of excess leverage in the banking sector, introducing additional safeguards against model risk and measurement errors. The ratio is a volume-based measure calculated as Basel III tier 1 capital divided by total on- and off-balance sheet exposures. Basel III provides for a transitional period for the introduction of this ratio, comprising a supervisory monitoring period that started in 2011 and a parallel run period from January 2013 to January 2017. The parallel run will be used to assess whether the proposed minimum ratio of 3% is appropriate, with a view to migrating to a Pillar 1 requirement from 1 January 2018.

RWA Planning (unaudited)

Pre-tax return on RWAs is an operational metric by which the global businesses are managed on a day-to-day basis. The metric combines return on equity and regulatory capital efficiency objectives. RWA targets, approved annually by the Board, are established for our global businesses and regions in accordance with the Group's strategic direction and risk appetite.

Business performance against the targets is monitored through reporting to the Asset and Liability Committee of Hang Seng Bank Limited. A range of analysis is employed in the RWA monitoring framework to identify the key drivers of movements in the position, such as book size and book quality. Particular attention is paid to identifying and segmenting items within the day-to-day control of the business and those items that are driven by changes in risk models or regulatory methodology.

Management Discussion and Analysis (continued)

Capital Management (continued)

Capital Base (unaudited)

The following tables show the capital base, risk-weighted assets and capital ratios as contained in the "Capital Adequacy Ratio" return required to be submitted to the HKMA by Hang Seng Bank on consolidated basis as specified by the HKMA under the requirements of section 3C(1) of the Banking (Capital) Rules.

The definition of regulatory capital under Basel III is different from that under Basel II which was used at 31 December 2012. The capital disclosures for 31 December 2013 are, therefore, not directly comparable with the disclosures for 31 December 2012 prepared under Basel II basis. Certain comparative figures have not been provided where the current year is the first year of disclosure.

The Bank and its subsidiaries maintain a regulatory reserve to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2013, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK\$5,440m (31 December 2012: HK\$4,866m).

There are no relevant capital shortfalls in any of the Group's subsidiaries as at 31 December 2013 (31 December 2012: nil) which are not included in the Group's consolidation for regulatory purposes.

The following table sets out the composition of the Group's capital base under Basel III at 31 December 2013. A more detailed breakdown of the capital position is available in the Regulatory Disclosures section of our website www.hangseng.com.

	2013
Common Equity Tier 1 ("CET1") Capital	
Shareholders' equity	98,068
- Shareholders' equity per balance sheet	107,778
- Unconsolidated subsidiaries	(9,710)
Regulatory deductions to CET1 capital	(41,329)
- Cash flow hedging reserve	(6)
- Changes in own credit risk on fair valued liabilities	(4)
- Reserves arising from revaluation of property ¹	(20,481)
- Regulatory reserve	(5,440)
- Intangible assets	(401)
- Defined benefit pension fund assets	(33)
- Deferred tax asset net of deferred tax liabilities	(43)
- Valuation adjustments	(180)
- Significant capital investments in unconsolidated financial sector entities	(500)
- Excess AT1 deductions	(14,241)
Total CET1 Capital	56,739
Additional Tier 1 ("AT1") Capital	
Total AT1 capital before regulatory deductions	-
Regulatory deductions to AT1 capital	-
- Significant capital investments in unconsolidated financial sector entities	(14,241)
- Excess AT1 deductions	14,241
Total AT1 Capital	-
Total Tier 1 ("T1") Capital	56,739
Tier 2 ("T2") Capital	
Total T2 capital before regulatory deductions	22,518
- Term subordinated debt	10,872
- Property revaluation reserves ¹	9,216
- Impairment allowances and regulatory reserve eligible for inclusion in T2 capital	2,430
Regulatory deductions to T2 capital	(14,241)
- Significant capital investments in unconsolidated financial sector entities	(14,241)
Total T2 capital	8,277
Total Capital	65,016

¹ Includes the revaluation surplus on investment properties which is reported as part of retained profits and related adjustments made in accordance with the Banking (Capital) Rules issued by the HKMA.

Risk-weighted assets by risk type (unaudited)

	2013
Credit risk	
Standardized approach	28,225
IRB approach	336,852
Market risk	4,293
Operational risk	41,100
Total	410,470

Management Discussion and Analysis (continued)

Capital Management (continued)

Market risk-weighted assets <i>(unaudited)</i>	2013
Internal models approach	
VAR	612
Stressed VAR	3,470
Standardised approach	
Specific interest rate exposures	211
Equity exposures	-
Total	4,293

Capital ratios (as a percentage of risk-weighted assets) *(unaudited)*

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

	2013
CET1 capital ratio	13.8%
Tier 1 capital ratio	13.8%
Total capital ratio	15.8%

Principal subsidiaries and basis of consolidation *(unaudited)*

The basis of consolidation for financial accounting purposes is in accordance with Hong Kong Financial Reporting Standards ("HKFRS"), as described in note 1 to the financial statements.

Subsidiaries included in the consolidation for regulatory purposes are specified in a notice from the HKMA in accordance with section 3C(1) of the Banking (Capital) Rules.

Subsidiaries not included in consolidation for regulatory purposes are securities and insurance companies that are authorised and supervised by a regulator and are subject to supervisory arrangements regarding the maintenance of adequate capital to support business activities comparable to those prescribed for authorised institutions under the Banking (Capital) Rules and the Banking Ordinance. The capital invested by the Group in these subsidiaries is deducted from the capital base as determined in accordance with Part 3 of the Banking (Capital) Rules.

A list of these subsidiaries is shown below:

<i>in HK\$ thousands</i>	Principal activities	2013	Total assets*	Total equity*
Hang Seng (Nominee) Ltd	Nominee service	121	100	
Hang Seng Bank (Trustee) Ltd	Trustee service	5,159	3,000	
Hang Seng Futures Ltd	Futures brokerages	102,470	101,680	
Hang Seng Investment Management Ltd	Fund management	714,999	602,339	
Hang Seng Investment Services Ltd	Provision of investment commentaries	8,683	8,683	
Hang Seng Securities Ltd	Stockbroking	3,019,072	1,450,947	
Hang Seng Insurance Co. Ltd	Retirement benefits and life assurance	95,735,833	8,796,052	
Hang Seng Insurance (Bahamas) Ltd	Insurance business	-	-	
Hang Seng Bank Trustee International Ltd	Trust business	15,526	11,735	

* Prepared in accordance with HKFRS/ IFRS

As at 31 December 2013, there are no subsidiaries which are included within both the accounting scope of consolidation and the regulatory scope of consolidation but the method of consolidation differs.

There are also no subsidiaries which are included within the regulatory scope of consolidation but not included within the accounting scope of consolidation.

The Group operates subsidiaries in different territories where capital is governed by local rules and there may be restrictions on the transfer of regulatory capital and funds between members of the Group.

Management Discussion and Analysis (continued)

Capital Management (continued)

Capital instruments (unaudited)

The following is a summary of the Group's CET1 and Tier 2 capital instruments.

	2013
CET1 capital instruments issued by the Bank	
Ordinary shares:	
1,911,842,736 issued and fully paid ordinary shares of HK\$5 each	9,559
Tier 2 capital instruments	
<u>Issued by the Bank:</u>	
Subordinated loan due 2020 (nominal value: US\$775m)	6,009
Subordinated loan due 2021 (nominal value: US\$450m)	3,489
Subordinated loan due 2022 (nominal value: US\$300m)	2,326

A description of the main features and the full terms and conditions of the Group's capital instruments can be found in the Regulatory Disclosures section of our website www.hangseng.com.

Additional information

A full reconciliation between the Group's accounting and regulatory balance sheets can be viewed in the Regulatory Disclosures section of our website www.hangseng.com.

Management Discussion and Analysis (continued)

Capital Management (continued)

Capital Base (unaudited)

The capital base after deductions used in the calculation of capital adequacy ratios as at 31 December 2012 and reported to the HKMA is analysed as follows:

	2012
Core capital:	
Paid-up ordinary share capital	9,559
- Reserves per balance sheet	78,940
- Unconsolidated subsidiaries	(8,872)
- Cash flow hedging reserve	(17)
- Regulatory reserve	(4,866)
- Reserves arising from revaluation of property and unrealised gains on available-for-sale equities and debt securities	(18,936)
Total reserves included in core capital	46,249
- Goodwill, intangible assets and valuation adjustment	(965)
- 50% of unconsolidated investments	(13,683)
- 50% of securitisation positions and other deductions	(158)
Deductions	(14,806)
Total core capital	41,002
Supplementary capital:	
- Term subordinated debt	11,821
- Property revaluation reserves ¹	5,894
- Available-for-sale investments revaluation reserves ²	183
- Regulatory reserve ³	303
- Collective impairment allowances ³	46
- Excess impairment allowances over expected losses ⁴	1,727
Supplementary capital before deductions	19,974
- 50% of unconsolidated investments	(13,683)
- 50% of securitisation positions and other deductions	(158)
Deductions	(13,841)
Total supplementary capital	6,133
Capital base	<u>47,135</u>
Risk-weighted assets	
- credit risk	295,743
- market risk	2,447
- operational risk	37,827
	<u>336,017</u>
- Capital adequacy ratio	14.0%
- Core capital ratio	12.2%
Reserves and deductible items	
Published reserves	39,152
Profit and loss account	7,097
Total reserves included in core capital	<u>46,249</u>
Total of items deductible 50% from core capital and 50% from supplementary capital	<u>27,682</u>

¹ Includes the revaluation surplus on investment properties which is reported as part of retained profits and adjustments made in accordance with the Capital Rules.

² Includes adjustments made in accordance with the Capital Rules.

³ Total regulatory reserve and collective impairment allowances are apportioned between the standardised approach and internal ratings-based approach in accordance with the Capital Rules. Those apportioned to the standardised approach are included in supplementary capital. Those apportioned to the internal ratings-based approach are excluded from supplementary capital.

⁴ Excess impairment allowances over expected losses are applicable to non-securitisation exposures calculated by using the internal ratings-based approach.

CORPORATE RESPONSIBILITY

Eight decades on from our establishment in 1933, our central founding principle – service excellence – remains crucial to our success.

As the leading domestic bank in Hong Kong and a good corporate citizen, our commitment to serve extends beyond our business operations. We participate in a diverse range of programmes that drive long-term social development in our communities.

Our investment in the future is helping to create a healthy, well-educated and inclusive society that will, in turn, support our sustainable growth in the years ahead.

We uphold high sustainability standards in managing our operations and use our extensive network of service channels and strong relationships with customers to inform, influence and inspire individuals and businesses to be agents of positive change in the community. We establish long-term partnerships with leading local non-governmental organisations and other institutions that are working to improve well-being and build a bright tomorrow.

In a testament to our local leadership in sustainable development, we were the only Hong Kong corporation recognised by Corporate Knights as one of the 'Global 100 Most Sustainable Corporations in the World' for a second consecutive year.

Beginning with our 2010 Corporate Responsibility (CR) Report, we were the first local bank in Hong Kong to employ the internationally recognised Global Reporting Initiative (GRI) sustainability reporting guidelines. Our two most recent CR Reports received an A+ GRI rating – the highest accreditation available.

In 2011, we became the first local Hong Kong bank to be included as a constituent member of the Dow Jones Sustainability Asia Pacific Index. We have been a member of the FTSE4Good Global Index since 2001 and of the Hang Seng Corporate Sustainability Index since 2010.

We are also committed to engaging our internal stakeholders. Our people are more than just employees – they are the human face of our business. We strive to provide our most valuable assets with the support, skills and working conditions they need to perform at their best and help us deliver service excellence.

Two interactive forums with 2012 Olympic bronze medal winner Lee Wai-sze and Dr Rosanna Wong of the Hong Kong Federation of Youth Groups promoted positive messages about the importance of dedication, drive and engaging with young people to over 500 Bank colleagues.

Our efforts to encourage physical well-being and a good work-life balance brought over 23,600 staff members, family and friends together in a spirit of cooperation and fun through a range of recreational and social events – including six sporting competitions held under the Hang Seng Cup.

We are proud to have been recognised as Hong Kong's most attractive employer in the banking and financial services sector in the 2013 Randstad Award.

We integrated corporate responsibility into our year-long series of activities to celebrate our 80th anniversary, including committing to build a further 800 biogas facilities in rural mainland China, requesting that guests at our anniversary cocktail reception make donations to The Community Chest of Hong Kong in lieu of sending flowers, and organising a special sports-themed fun day for staff and their families.

Investing in Our Future

We believe in facilitating wider access to educational and social enrichment opportunities and in promoting the benefits of a healthy lifestyle. We also seek to inspire and empower underprivileged groups and break down barriers to social integration.

Since 2004, we have provided about HK\$240m in financial support – including HK\$27m in 2013 – for community development initiatives. In line with our belief that building strong human connections underpins lasting positive change, our staff also give their time to serve worthy causes. Bank

volunteers and their families contributed nearly 27,000 hours during 2013. We facilitated this giving back to society by organising over 150 volunteer activities, with a particular focus on underprivileged children, elderly people living alone and environmental education.

Our partnership with The Community Chest – which stretches back more than 25 years – has raised over HK\$65m for 157 local charities. We have participated in The Chest's Dress Casual Day since 1997, matching staff donations on a dollar-for-dollar basis – resulting in more than HK\$18m in support.

We continue to work with the Regeneration Society to promote positive life values through the Hang Seng Bank – Regeneration Society Top Ten Regeneration Warriors Programme, under which 10 'Regeneration Warriors' share their experiences in overcoming chronic illness or severe physical disabilities to live rich and fulfilling lives.

Youth development

Since 1995, we have allocated more than HK\$62m to our scholarship schemes, assisting over 2,000 students from Hong Kong and the Mainland. Our Community Scholarships programme rewards outstanding undergraduate students in Hong Kong who have contributed to community development with a minimum of 100 hours of volunteer service in the previous 12 months. On the Mainland, we awarded 120 scholarships to students for undergraduate and postgraduate studies at 21 leading Mainland universities in 2013.

We joined hands with The Hong Kong Council of Social Service (HKCSS) in 2013 to organise the Hang Seng – HKCSS Youth Career Exploration Programme. Designed to nurture a positive mindset towards career development among young people and encourage upward social mobility, participating students are exposed to the operations of companies working in three diverse sectors that collectively represent both newly developing and well-established industries in Hong Kong. This experience provides a unique insight into the characteristics and potential of various industries, equipping young people to make better decisions in choosing a career path that aligns with their personal strengths and interests.

The Hang Seng – Hong Kong Family Welfare Society Youth Mediation Scheme helps build stronger relationships by promoting a positive attitude among students in resolving conflicts with their family members. Over 300 students from 15 primary schools were trained as 'Peer Mediators' in 2013. Hang Seng staff volunteers were also trained as 'Hang Seng Mediation Ambassadors' to assist at the student-family workshops.

The Tung Wah – Hang Seng Code Kidz Programme Supports Children with Specific Learning Disabilities (SLDs) promotes greater public understanding of the social challenges for children living with SLDs, while also providing opportunities for young people to explore their potential through alternative ways of learning. Over 1,000 youngsters and their family members benefitted from more than 500 activities in the 2012/13 programme year.

More than 420 students from 170 schools took part in the Ming Pao Student Reporter Programme in 2013. Our sponsorship of the Programme – which includes a series of media workshops, newsroom visits and reporting activities – has now helped over 7,000 students build greater social awareness and news sense while developing their critical analysis and language skills.

Sports development

Our support for sports development aims to improve community health, harness the power of physical achievement to build confidence and esteem, and support greater social cohesion by encouraging cooperation, dedication and fair play.

Since 1991, we have provided over HK\$38.5m to promote table tennis in Hong Kong. Established in partnership with the Hong Kong Table Tennis Association in 2001, the Hang Seng Table Tennis Academy nurtures rising young table tennis stars and provides the wider community with the chance to test their sporting skills. Over the past 13 years, the Academy has organised over 4,400 activities for more than 230,000 participants. Our continuing support for the Academy includes HK\$7.5m in sponsorship for 2013-15.

Hong Kong's top athletes not only unite the community through a sense of collective pride, but also serve as positive role models for the rewards of commitment, determination and teamwork.

Under the Hang Seng Athlete Incentive Awards Scheme, a joint initiative with the Hong Kong Sports Institute, we awarded over HK\$2.5m in 2013 to Hong Kong athletes who gave their best to win medals at the National Games and East Asian Games. Since 1996, the Scheme has given out HK\$33m to reward athletic achievement and encourage sporting excellence by local athletes at major national and international games.

Cultural development

Building for a positive future requires creative and inquiring minds. By facilitating broader exposure to culture and the arts, we hope to spark the imagination and talent that will help our community blossom and grow.

A series of more than 80 Hang Seng Arts Empowerment Workshops, organised in partnership with the Jockey Club Creative Arts Centre, provided 1,600 students from low-income families with the opportunity to explore their abilities, build greater self-confidence and express their emotions through a range of artistic activities. The programme included a post-Workshop exhibition to showcase a variety of student creations.

To encourage closer family ties and compassionate understanding across the generations, we are working with the Hong Kong Repertory Theatre to organise three exclusive screenings for students from underprivileged families and family members of patients suffering from dementia under the Hang Seng Bank Student and Community Matinees Programme.

Since 2007, our sponsorship of Student Ticket Schemes for Hong Kong Arts Festival events and performances by the Hong Kong Philharmonic Orchestra has benefitted over 82,000 students.

Vision for a Greener Tomorrow

The collective global response to challenges such as climate change and conserving biodiversity will influence the long-term health of the natural systems upon which we all depend. As one of Hong Kong's largest listed companies, we have a strong platform from which to champion the cause of improved environmental stewardship.

We strive to reduce our waste production and consumption of energy and natural resources and, whenever possible, to use environmentally friendly products and certified materials in our operations. We empower our staff to act as ambassadors for the environment by raising their awareness of green issues and use our services and policies to encourage greener practices among our customers and suppliers.

Beginning with our headquarters building in 2005, we have led the way in gaining ISO 14001 certification among domestic banks in Hong Kong. In 2011, we became the first local bank to achieve this internationally recognised environmental accreditation for all Hong Kong offices and branches.

Our e-Statement and e-InvestAdvice services offer e-Banking customers the option to receive account statements and other notices in electronic rather than paper format. At the end of 2013, the number of e-Statement subscribers was more than 1.26 million and over 92,000 customers were using e-InvestAdvice – collectively saving more than 42 million sheets of paper a year.

We committed to sponsoring the construction of a further 800 biogas facilities on the Mainland – our largest undertaking since establishing the Hang Seng Yunnan Biogas Project in cooperation with The Conservancy Association in 2007. To date, we have helped build 3,000 biogas facilities in Yunnan province to provide a free and stable source of energy for more than 12,000 rural residents and reduce annual carbon dioxide emissions by over 35,000 tonnes.

New steps in our work with the southern China business community on environmental issues include expanding the coverage of our environmental awards to cover the pan Pearl River Delta region. Organised jointly with the Federation of Hong Kong Industries, the Hang Seng Pan Pearl River Delta Environmental Awards (Awards) aim to serve as a catalyst for positive environmental change among

manufacturing companies in this economically vibrant region by recognising and rewarding environmentally responsible behaviour.

With a 20% increase in the number of applications compared with the previous Awards year, over 720 projects were submitted to the 2012/13 Awards by 225 participants. Collective achievements included cutting consumption of electricity by over 126 million kilowatt hours and water usage by more than 4.2 million tonnes.

We also reach out to the wider community through actions such as our sponsorship of the Friends of the Earth (HK) 'Power Smart' Energy Saving Competition and holding the Hang Seng Green Carnival in partnership with The Conservancy Association.

To support the conservation of biodiversity, we stopped serving shark's fin at Bank functions in 2003 and have since removed endangered reef fish from our menus. We comply with WWF Hong Kong's *Seafood Guide* and provide a sustainable seafood menu at our banquet hall. Since 1999, we have planted around 93,000 trees – including 23,000 in 2013 – in Hong Kong and on the Mainland.

Environmental Performance Table

	2013 [#]	2012 [^]	2013 vs 2012 (%)
Greenhouse gas emissions (kilotonnes CO ₂)	24.31	24.34	-0.14
Electricity consumption (GWh)	35.27	36.61	-3.66
Water consumption (000 m ³)	64.81	65.90	-1.66
IT/electrical waste recycled (tonnes)	58.84	54.94	7.09

Data coverage: Hang Seng Bank's Hong Kong operations

Key:

m³: Cubic metres CO₂: Carbon dioxide

GWh: Gigawatt hours

[#] From 1 Oct 2012 to 30 Sep 2013

[^] From 1 Oct 2011 to 30 Sep 2012

KEY INITIATIVES

Guiding future leaders

Our participation in youth development initiatives such as the Hang Seng Bank Leaders to Leaders Lecture Series – organised by the Hong Kong Federation of Youth Groups and The University of Hong Kong – is an important part of our work to groom well-rounded leaders of tomorrow for a better future for all.

The 2013 Lecture Series gave youngsters a valuable opportunity to engage in direct dialogue with prominent community leaders on important social issues. To open up access to a wider audience, the Series was broadcast live via webcast for the first time, reaching over 30,000 participants.

Conservation drives well-being

The Hang Seng Yunnan Biogas Project has been driving positive social and environmental development in mainland China's Yunnan province since 2007. The biogas facilities help conserve natural resources and protect the environment, while also bringing positive change to the lives of villagers by reducing energy costs by up to 50% when compared to using firewood. The Project is also saving more than 2,400 acres of forest every year – equivalent to an area that is 75 times the size of Kowloon Park.

Inspired by the warrior spirit

Since 2008, the Hang Seng Bank – Regeneration Society Top Ten Regeneration Warriors Programme has promoted the power of positive thinking and self-belief in overcoming life's challenges. Including a large-scale ceremony held at the Hong Kong Exhibition and Convention Centre, the programme facilitated around 50 experience-sharing sessions in 2013, at which over 20,000 participants were inspired by the real-life experiences of individuals who have demonstrated courage and determination in dealing with serious illness or physical disability.

RECOGNITION

A constituent stock of the Dow Jones Sustainability Asia Pacific Index

Dow Jones Sustainability Index

A constituent stock of the FTSE4Good Global Index (for 12th consecutive year)

FTSE Index

Global 100 Most Sustainable Corporations in the World

Corporate Knights

Caring Company (for 11th consecutive year)

Hong Kong Council of Social Service

CORPORATE GOVERNANCE AND OTHER INFORMATION

CORPORATE GOVERNANCE PRINCIPLES AND PRACTICES

Hang Seng Bank Limited (the “Bank”) is committed to high standards of corporate governance with a view to safeguarding the interests of shareholders, customers, staff and other stakeholders. The Bank has followed the module on “Corporate Governance of Locally Incorporated Authorised Institutions” under the Supervisory Policy Manual (“SPM”) issued by the Hong Kong Monetary Authority (“HKMA”). The Bank has also fully complied with all the code provisions and most of the recommended best practices as set out in the Corporate Governance Code contained in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the “Listing Rules”), save that the Risk Committee (all the members of which are Independent Non-executive Directors (“INEDs”)), which was established pursuant to HKMA’s SPM on corporate governance, is responsible for the oversight of internal control (other than internal control over financial reporting) and risk management systems. If there were no Risk Committee, these matters would be the responsibility of the Audit Committee, as provided under the aforesaid Corporate Governance Code. The Bank also constantly reviews and enhances its corporate governance framework to ensure that it is in line with international and local best practices.

BOARD OF DIRECTORS

The Board has collective responsibilities for promoting the long-term sustainability and success of the Bank by providing entrepreneurial leadership within a framework of prudent and effective controls. In doing so, the Board commits to high standards of integrity and ethics.

According to the Board’s terms of reference, specific matters reserved for the Board’s consideration and decision include:

- strategic plan and objectives;
- annual operating plans and performance targets;
- annual and interim financial reporting;
- capital plans and management;
- risk appetite statement and profile;
- internal control and risk management governance;
- significant policies such as large credit exposure policy, liquidity management policy, remuneration policy and policy on board-level conflicts of interest;
- significant changes to balance sheet management policies;
- policies, practices and disclosure on corporate governance;
- policies and practices on compliance with legal and regulatory requirements;
- appointment and oversight of senior management;
- corporate values and standards;
- corporate structure;
- effective audit functions;

- transparency in respect of the structure, operation and risk management; and
- acquisitions and disposals above predetermined thresholds.

Chairman and Chief Executive

The roles of the Chairman and Chief Executive of the Bank are separate, with a clear division of responsibilities as set out in the Board's terms of reference.

The Chairman of the Board is an INED who is responsible for the leadership and effective running of the Board and for ensuring that decisions of the Board are taken on a sound and well-informed basis and in the best interest of the Bank. The Chairman possesses the requisite experience, competencies and personal qualities to fulfill these responsibilities.

The Chief Executive is an Executive Director who ensures implementation of the strategy and policy as established by the Board. The Chief Executive is responsible for the management and day-to-day running of the Bank's business and operations, and leads and chairs the Executive Committee.

Board Composition

As at the date of this Annual Report, the Board comprises 14 Directors, of whom three are Executive Directors and 11 are Non-executive Directors ("NEDs"). Of the 11 NEDs, eight are INEDs. There is a strong independent element on the Board, to ensure the independence and objectivity of the Board's decision-making process as well as the thoroughness and impartiality of the Board's oversight of the Management.

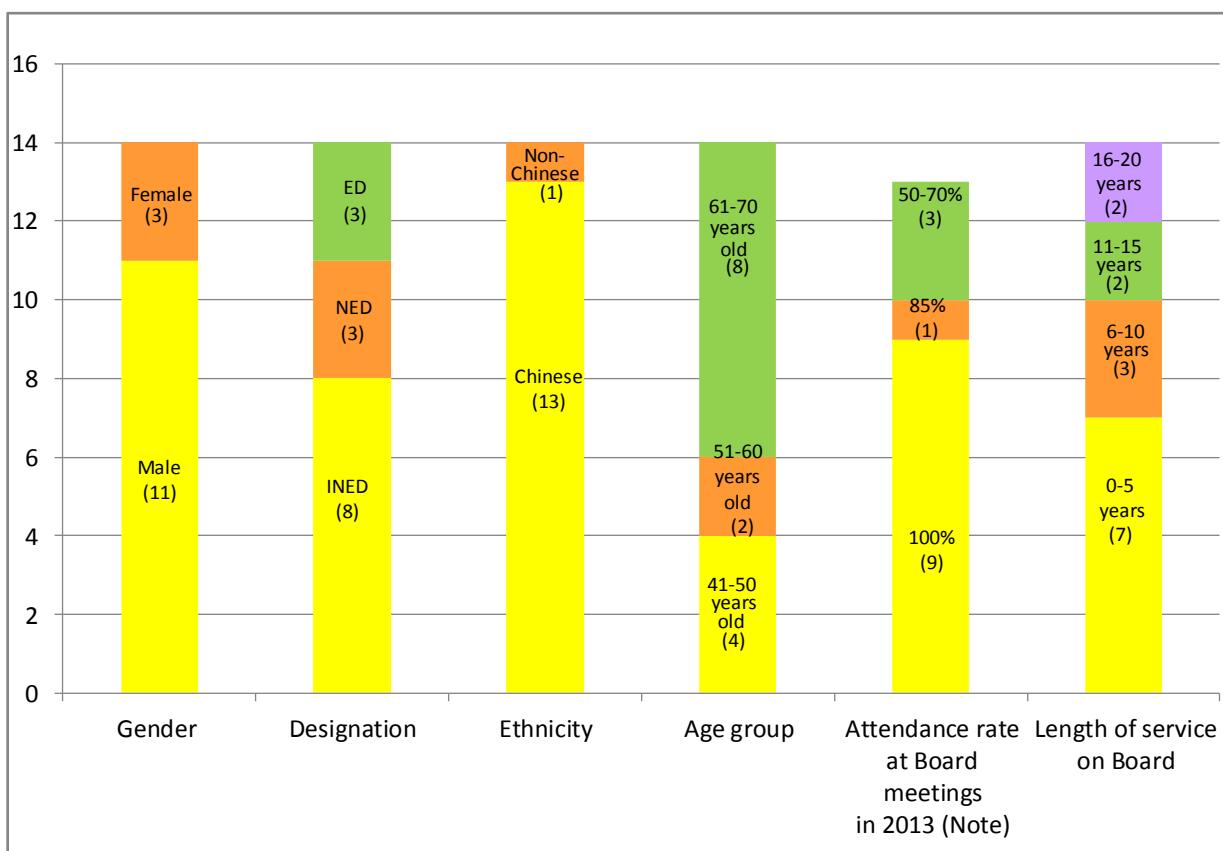
The Board possesses, both as individual Directors and collectively, appropriate experience, competencies and personal qualities, including professionalism and integrity, to discharge its responsibilities adequately and effectively. In addition, the Board collectively has adequate knowledge and expertise relevant to each of the material business activities that the Bank pursues and the associated risks in order to ensure effective governance and oversight.

Members of the Board, who come from a variety of different backgrounds, have a diverse range of business, banking and professional expertise. Brief biographical particulars of 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.

The Board considers that its diversity, including gender diversity, is a vital asset to the business. In May 2013, the Board adopted a Board Diversity Policy which has been made available on the Bank's website (www.hangseng.com) for better transparency and governance. Board appointments are based on merit and candidates are considered against objective criteria, having due regard for the benefits of diversity on the Board, including but not limited to gender, age, cultural and educational background, ethnicity, professional experience, skills, knowledge and length of service. The Bank remains committed to meritocracy in the Boardroom, which requires a diverse and inclusive culture where Directors believe that their views are heard, their concerns are attended to and they serve in an environment where bias, discrimination and harassment on any matter are not tolerated.

An analysis of the Board's current composition is set out in the following chart:

No. of Directors



Note : Mr Nixon L S Chan was newly appointed in 2014 and hence he has not attended any Board meetings held in 2013 in his capacity as a Director.

The Bank has maintained on its website (www.hangseng.com) and on the website of Hong Kong Exchanges and Clearing Limited (www.hkexnews.hk) an updated list of its Directors identifying their roles and functions and whether they are INEDs. INEDs are also identified as such in all corporate communications that disclose the names of the Bank's Directors.

Further, the Bank has received from each of the INEDs an annual confirmation of his/her independence. The independence of the INEDs has been assessed in accordance with the guidelines set out in Rule 3.13 of the Listing Rules. Following such assessment, the Board has affirmed that all the INEDs continue to be independent.

The Bank issues appointment letters to each of the NEDs, setting out the terms and conditions of their appointment, including the time commitment expected of them. Additional time commitment is necessary if the NEDs also serve on committee(s) of the Board.

Board Process

Board meetings shall be held at least once every quarter. Additional Board meetings, or meetings of a board committee established by the Board to consider specific matters, can be convened, when necessary.

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

Other than regular Board meetings, the Chairman also meets with NEDs, including INEDs, without the presence of the Executive Directors, to facilitate an open and frank discussion among the NEDs on issues relating to the Bank.

Meeting agendas for regular Board meetings are set after consultation with the Chairman and the Chief Executive. All Directors are given an opportunity to include matters in the agenda. Regular reports include the Bank's financial performance, strategic plan, annual operating plan and capital plan, risk appetite statement and profile, review of internal control and risk management framework, results of stress testings, as well as reports on large credit exposures and connected lendings.

Directors make their best efforts to contribute to the formulation of strategy, policies and decision-making by attending the Board meetings in person or via telephone or video conference facilities.

Minutes of Board/board committee meetings with details of the matters discussed by the Board/board committees and decisions made, including any concerns or views of the Directors/board committee members, are kept by the Company Secretary and are open for inspection by Directors/board committee members. Chairmen of board committees report on important issues discussed and reviewed by the committees, at each Board meeting.

During 2013 the Board held six meetings and the important matters discussed at Board meetings included :

- financial and business performance;
- strategic plan 2013 – 2015 with quarterly updates;
- risk appetite statement and profile;
- annual operating plan and capital plan;
- capital management and internal capital adequacy assessment process;
- results of enterprise stress testing analysis;
- significant policies such as Large Credit Exposure Policy, Liquidity Management Policy, Shareholders Communication Policy, Policy on Conflicts of Interest and Board Diversity Policy;
- review of the Bank's remuneration policy and remuneration system;
- appointments of Directors and senior executives;
- re-election and election of the retiring Directors and terms of appointment of NEDs;
- review of independence of INEDs;
- succession planning for the Board;
- pay review for 2013 and variable pay for 2012;
- review of the fees payable to Directors and Board Committee Chairmen/members of the Bank and its subsidiaries;
- performance management and succession policy for senior management;
- risk management framework and internal control framework;
- corporate governance strategy, framework, and practices and procedures; and
- major regulatory changes affecting the Bank.

In addition to the regular financial performance reports submitted to the Board at its regular meetings, the Board also receives financial and business updates with information on the Bank's latest financial performance and material variance from the Bank's annual operating plan during those months where no Board meetings will be held. Directors can therefore have a balanced and understandable assessment of the Bank's performance, position and prospects throughout the year.

The Board reviews and evaluates its work process and effectiveness annually, with a view to identifying areas for improvement and further enhancement. The Board also regularly reviews the time commitment required from NEDs.

All Directors have access to the Executive Directors as and when they consider necessary. They also 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.

In July 2013, the Board adopted a Policy on Conflicts of Interest. The Policy identifies the relationships, services, activities or transactions in respect of which conflicts of interest may arise and sets out measures for prevention or management of these conflicts. The Policy also contains an objective compliance process for implementing the Policy which includes notification by a Director of conflicts or potential conflicts, and a review/approval process.

Appointment and Re-election of Directors

The Bank uses a formal, considered and transparent procedure for the appointment of new Directors. Before a prospective Director's name is formally proposed, opinions of the existing Directors (including the INEDs) will be solicited. The proposed appointment will first be reviewed by the Nomination Committee, taking into account the balance of skills, and knowledge and experience on the Board. Upon recommendation of the Nomination Committee, the proposed appointment will then be reviewed and, if thought fit, approved by the Board after due deliberation. In accordance with the requirement under the Banking Ordinance, approval from HKMA will also be obtained. All new Directors are subject to election by shareholders of the Bank at the next Annual General Meeting ("AGM") after their appointments have become effective.

According to the policy on the term of appointment of NEDs, term of appointment of each NED is three years except that where a NED has served on the Board for more than nine years, then his/her term of appointment is one year. In renewing the term of appointment of each NED, the Board reviews whether such NED remains qualified for his/her position.

The Bank's Articles of Association provide that one-third (or the number nearest to but not exceeding one-third) of the Directors shall retire from office every year at the Bank's AGM. Retiring Directors are eligible for re-election at AGMs of the Bank.

Responsibilities of Directors

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. In particular, through regular Board meetings and receipt of financial and business updates, all Directors are kept abreast of the conduct, business activities and development, as well as regulatory updates applicable to the Bank.

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 Management.

The Bank has adopted a Code for Securities Transactions by Directors on terms no less exacting than the required standards as set out in the Model Code for Securities Transactions by Directors of Listed Issuers (as set out in Appendix 10 to the Listing Rules). Specific enquiries have been made with all Directors who have confirmed that they have complied with the Bank's Code for Securities Transactions by Directors throughout the year of 2013.

Directors' interests in securities of the Bank and HSBC Holdings plc ("HSBC") as at 31 December 2013 have been disclosed in the Report of the Directors as set out in this Annual Report.

Appropriate Directors' liability insurance cover has also been arranged to indemnify the Directors for liabilities arising out of corporate activities. The coverage and the sum insured under the policy are reviewed annually. Further, the Bank's Articles of Association provide that Directors are entitled to be indemnified out of the Bank's assets against claim from third parties in respect of certain liabilities.

Induction and Training for Directors

Induction programmes on the following key areas are arranged for newly appointed Directors so that they can discharge their responsibilities to the Bank properly and effectively :

- the Bank's business operations in Hong Kong;
- the Bank's business operations and investments on the Mainland;
- the Bank's control and support functions; and
- directors' duties and responsibilities.

Further, all Directors are provided with briefings and trainings on an on-going basis as necessary to ensure that they have a proper understanding of the Bank's operations and business and are fully aware of their responsibilities under the applicable laws, rules and regulations, including but not limited to the Listing Rules, Companies Ordinance, Securities and Futures Ordinance and HKMA's SPMs. Such briefings and trainings are provided at the Bank's expenses. The Bank also maintains proper records of the trainings provided to and received by its Directors.

During the year, all Directors received briefings or trainings in relation to the following topics :

- HKMA's expectations on Board involvement in anti-money laundering and counter-financing of terrorism;
- key takeaways from Group NEDs Forum, and Audit and Risk Chairmen Forum;
- revised SPMs issued by HKMA together with the Bank's compliance status;
- disclosure obligations under Part XV of the Securities and Futures Ordinance; and
- update on competition law.

To summarise, the Directors received trainings on the following areas to update and develop their skills and knowledge during the year ended 31 December 2013:

Directors ^{Note 1}	Training areas		
	Corporate governance	Regulatory	Business/Management
<i>INEDs</i>			
Dr Raymond K F Ch'ien	√	√	√
Dr John C C Chan	√	√	√
Dr Marvin K T Cheung	√	√	√
Ms L Y Chiang	√	√	√
Dr Fred Ziliu Hu	√	√	√
Dr Eric K C Li	√	√	√
Mr Richard Y S Tang	√	√	√
Mr Michael W K Wu	√	√	√
<i>NEDs</i>			
Ms Anita Y M Fung ^{Note 2}	√	√	√
Ms Sarah C Legg	√	√	√
Dr Vincent H S Lo	√	√	√
Mr Peter T S Wong	√	√	√
<i>Executive Directors</i>			
Ms Rose W M Lee	√	√	√
Mrs Dorothy K Y P Sit ^{Note 2}	√	√	√
Mr Andrew H C Fung	√	√	√

^{Note 1} Mr Jenkin Hui retired from the Board with effect from the conclusion of the AGM held on 16 May 2013 and Mr Nixon L S Chan was newly appointed in 2014. Accordingly, their training records have not been included above.

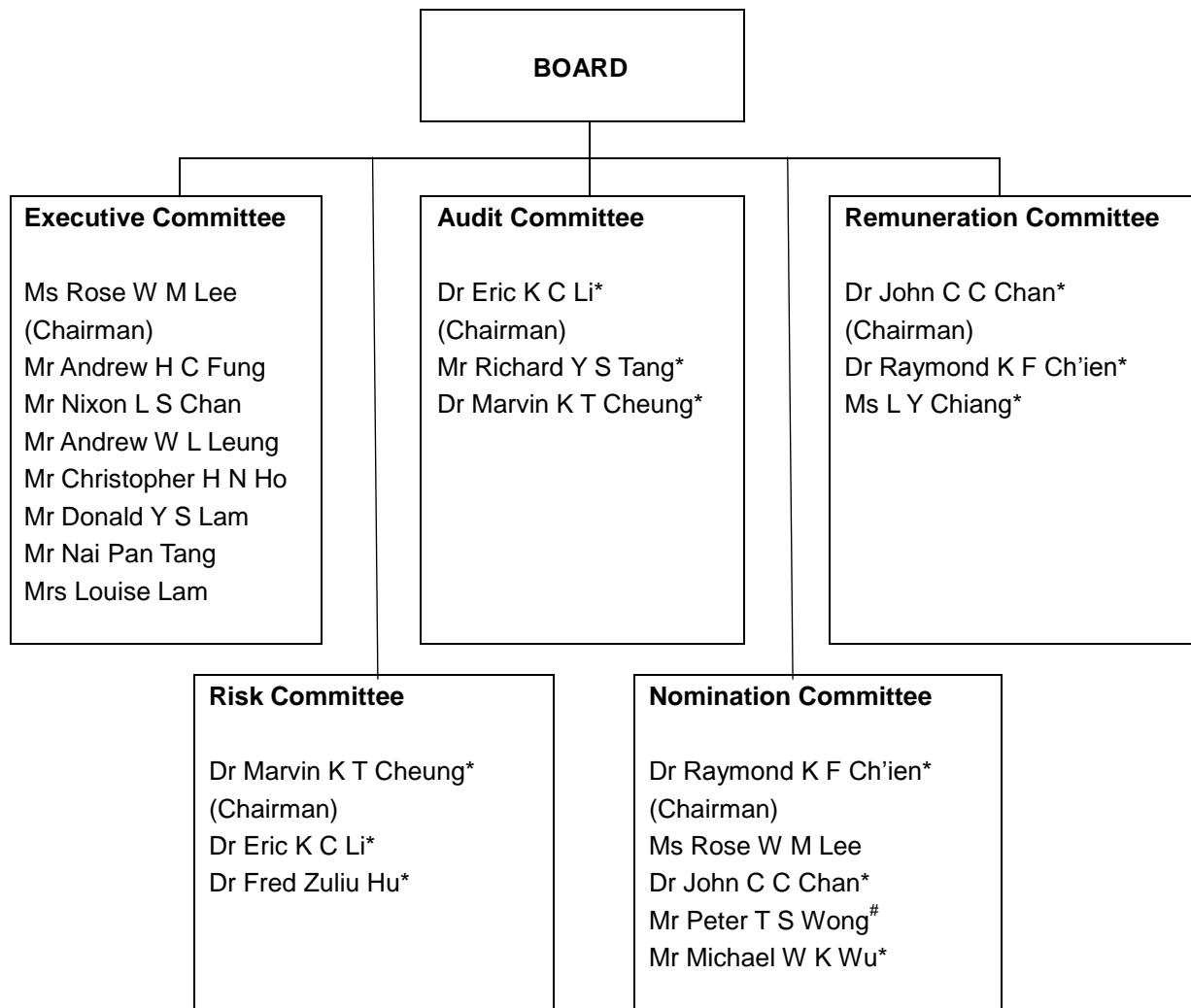
^{Note 2} Ms Anita Y M Fung stepped down from the Board with effect from 31 January 2014 and Mrs Dorothy K Y P Sit retired from the Board with effect from 1 January 2014.

DELEGATION BY THE BOARD

Board Committees

The Board has set up five Committees, namely, the Executive Committee, Audit Committee, Risk Committee, Remuneration Committee and Nomination Committee, to assist it in carrying out its responsibilities.

The current composition of the above Board Committees is as follows:



* INED

NED

Each of these Committees has specific written terms of reference, which set out in detail their respective authorities and responsibilities. Each Committee reviews its terms of reference and effectiveness annually. The terms of reference of all the non-executive Board Committees have been made available on the Bank's website (www.hangseng.com). All Committees, except the Executive Committee and Nomination Committee, comprise solely INEDs. Majority of the Nomination Committee members are INEDs while the Executive Committee comprises the Bank's senior management members. All Committees report back to the Board on their decisions or recommendations on a regular basis.

Executive Committee

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

To further enhance the Bank's risk management framework and in line with best practices, the Bank has set up a Risk Management Committee ("RMC"), chaired by the Bank's Chief Risk Officer, to centralise the risk management oversight function of the Bank and its subsidiaries. The RMC reports directly to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank, including all the eight types of risks stipulated in HKMA's SPMs, namely, credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal and compliance risk, reputation risk and strategic risk. In addition, the RMC also covers business (including insurance) risk, pension risk, security and fraud risk, and sustainability risk, and is responsible for approval of all risk management related policies. RMC meetings are usually held monthly. Minutes of RMC meetings are provided to the Executive Committee and the Risk Committee for review.

Audit Committee

The Audit Committee meets at least four times a year, with the Bank's executives including, but not limited to, the Chief Executive, Chief Financial Officer, Chief Risk Officer and Head of Audit, and representatives from the Bank's external auditor. The Committee reviews, 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 relating to financial reporting. The Audit Committee is also responsible for making recommendations to the Board on the appointment, re-appointment, removal and remuneration of the Bank's external auditor. In addition, the Audit Committee has established a "Policy for the Reporting of Improprieties" to provide a secured and confidential channel through which all staff members may report incidents of improprieties in a secured and confidential manner so that the same will be timely and thoroughly investigated and appropriate actions can be taken promptly.

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.

During the year, the Audit Committee held six meetings and the major work performed by the Committee was as follows:

- reviewed the Bank's financial statements for the year ended 31 December 2012 and the related documents, and the management letters and audit issues noted by the Bank's external auditor;
- reviewed the Bank's interim financial statements for the six months ended 30 June 2013 and the related documents, and the issues noted by the Bank's external auditor;
- reviewed essential matters or reports relating to financial control and reporting, and discussed the same with the Management;
- reviewed balance sheet management position;
- reviewed the Bank's 2013 annual operating plan and capital plan;
- reviewed the revised accounting standards and prospective changes to accounting standards, and the impact on the Bank's financial reporting;
- reviewed the internal audit reports, and discussed the same with the Management and Head of Audit;
- reviewed the internal audit plan for 2014;
- reviewed the remuneration and engagement letters of the Bank's external auditor, and its independence and objectivity, and the effectiveness of the audit process;

- reviewed the adequacies of resources, qualifications and experience of staff of the Bank's Accounting and Financial Reporting function and Internal Audit function, and their training programmes and budgets;
- reviewed the effectiveness of the Policy for the Reporting of Improprieties and the incidents reported through such channel during the year;
- reviewed the Audit Committee's effectiveness in discharging its role and responsibilities and its terms of reference and made recommendation to the Board for any changes; and
- exercised oversight over the audit committees of the Bank's principal subsidiaries.

The Audit Committee meets with the representatives of the Bank's external auditor and Head of Audit without the presence of the Management at least once a year. In addition, the Committee also meets with the representatives of HKMA to maintain a regular dialogue with the regulator and to share HKMA's general views on their supervisory focus.

Risk Committee

The Risk Committee meets at least four times a year, with the Bank's executives including, but not limited to, the Chief Financial Officer, Chief Risk Officer, Chief Compliance Officer, Head of Audit, and representatives from the Bank's external auditor. The Committee is responsible for, among other things, the Bank's high level risk related matters, risk appetite and tolerance, risks associated with proposed strategic acquisitions or disposals, risk management reports from the Management, effectiveness of the Bank's risk management framework and systems of internal control and compliance (other than internal control over financial reporting), and appointment and removal of the Bank's Chief Risk Officer.

The Risk Committee reports to the Board following each Risk 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.

During the year, the Risk Committee held four meetings and the major work performed by the Committee was as follows:

- reviewed routine risk reports submitted by the Management including, but not limited to, the Bank's risk management framework, risk appetite statement and profile, enterprise stress testing analysis, risk dashboards, risk maps, top and emerging risks, and reports relating to compliance and internal control;
- reviewed the Bank's capital management and internal capital adequacy assessment process;
- reviewed the Bank's progress in implementing Basel III;
- reviewed the management letters and audit issues noted by the Bank's external auditor insofar as the same related to risk issues/matters;
- reviewed the internal audit reports insofar as the same give rise to any risk-related issues;
- reviewed the adequacies of resources, qualifications and experience of staff of the Bank's Risk Management function, and their training programmes and budgets;
- reviewed regulatory review reports and discussed the same with the Management;
- reviewed the incidents reported under the Policy for the Reporting of Improprieties insofar as the same give rise to any risk-related issues;
- reviewed the Risk Committee's effectiveness in discharging its role and responsibilities and its terms of reference, and made recommendation to the Board for any changes; and
- exercised oversight over the risk committees of the Bank's principal subsidiaries.

The Risk Committee meets with the Bank's Head of Audit and Chief Risk Officer separately without the presence of the Management at least once a year.

Remuneration Committee

The Remuneration Committee meets at least twice a year, with the Bank's Head of Human Resources. The Committee considers and makes recommendations to the Board on the remuneration policy and structure in order to attract, motivate and retain quality personnel. Pursuant to delegation by the Board, the Committee also determines the remuneration policy, and the specific remuneration packages of all Executive Directors, senior management and key personnel. In addition, it also reviews at least annually and independently of the Management, the adequacy and effectiveness of the Bank's remuneration policy and its implementation to ensure that the Bank's remuneration policy is consistent with relevant regulatory requirements and promotes effective risk management.

In determining the bank-wide remuneration policy, the Remuneration Committee will take into account the Bank's business objective, people strategy, short-term and long-term performance, business and economic conditions, market practices and risk management needs, in order to ensure the remuneration aligns with business and individual performances, promotes effective risk management, facilitates retention of quality personnel and is competitive in the market. The Committee may invite any Director, executive, consultant or other relevant party to provide advice in this respect. In 2013, the Committee has not requested to seek advice from external consultant on matters relating to remuneration.

The Remuneration Committee reports to the Board following each 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.

During the year, the Remuneration Committee held two meetings and the major work performed by the Committee was as follows:

- reviewed and updated the Bank's remuneration policy to further strengthen the Bank's governance in response to the tightened regulatory requirements;
- reviewed the outcome of the review by the internal audit function of the Bank's remuneration policy and remuneration system, and the adequacy and effectiveness of its implementation;
- reviewed the fees payable to the Bank's Chairman, and the Directors and Board Committee Chairmen/members of the Bank and its subsidiaries, and recommended the same to the Board for approval;
- determined the remuneration packages of the Executive Directors, senior management and key personnel of the Bank, and the Vice-Chairman and Chief Executive of Hang Seng Bank (China) Limited;
- reviewed the report on the alignment of risk and remuneration;
- reviewed the proposed variable pay for 2012 and recommended the same to the Board for approval;
- reviewed the pay review proposal for 2013 and recommended the same to the Board for approval; and
- reviewed the Remuneration Committee's effectiveness in discharging its role and responsibilities and its terms of reference and made recommendation to the Board for any changes.

Nomination Committee

The Nomination Committee meets at least twice a year. It leads the process for Board appointments and identifies and nominates for the Board's approval, candidates for appointment to the Board. The Nomination Committee also considers, among other things, the structure, size and composition of the Board, independence of INEDs, term of appointment of and time required from NEDs, and appointment to Board Committees.

The Nomination Committee reports to the Board following each 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.

During the year, the Nomination Committee held two meetings and the major work performed by the Committee was as follows:

- reviewed the structure, size and composition of the Board;
- reviewed the succession planning for the Board;
- reviewed independence of INEDs;
- reviewed time commitment required from NEDs;
- recommended to the Board for approval the renewal of terms of appointment of NEDs;
- recommended to the Board for endorsement the re-election of the retiring Directors;
- reviewed and approved the revised appointment letter of NEDs;
- recommended to the Board for approval appointments of Directors;
- recommended to the Board for approval the Board Diversity Policy;
- recommended to the Board for approval the succession policy for senior management;
- recommended to the Board for approval the changes to the composition of Executive Committee, Remuneration Committee and Nomination Committee; and
- reviewed the Nomination Committee's effectiveness in discharging its role and responsibilities and its terms of reference and made recommendation to the Board for any changes.

Attendance Records

The attendance records of Board and Board Committee meetings held in 2013 are as follows:

	Meetings held in 2013						
	2013 AGM	Board	Executive Committee	Audit Committee	Risk Committee	Remuneration Committee	Nomination Committee
Number of Meetings	1	6	13	6	4	2	2
Directors							
Dr Raymond K F Ch'ien* <i>(Chairman)</i>	1/1	6/6	-	-	-	2/2	2/2
Ms Rose W M Lee <i>(Vice-Chairman and Chief Executive)</i>	1/1	6/6	12/13	-	-	-	2/2
Dr John C C Chan*	1/1	6/6	-	-	-	2/2	2/2
Dr Marvin K T Cheung*	0/1	4/6	-	4/6	3/4	-	-
Ms L Y Chiang* ^{Note 3}	1/1	6/6	-	-	-	1/1	-
Mr Andrew H C Fung	1/1	6/6	11/13	-	-	-	-
Ms Anita Y M Fung ^{# Note 4}	1/1	6/6	-	-	-	-	-
Dr Fred Ziliu Hu*	0/1	5/6	-	-	4/4	-	-
Mr Jenkin Hui* ^{Note 5}	1/1	3/3	-	-	-	1/1	1/1
Ms Sarah C Legg [#]	1/1	6/6	-	-	-	-	-
Dr Eric K C Li*	1/1	6/6	-	6/6	4/4	-	-
Dr Vincent H S Lo [#]	0/1	4/6	-	-	-	-	-
Mrs Dorothy K Y P Sit ^{Note 6}	1/1	6/6	3/4	-	-	-	-
Mr Richard Y S Tang*	1/1	6/6	-	6/6	-	-	-
Mr Peter T S Wong [#]	0/1	3/6	-	-	-	-	2/2
Mr Michael W K Wu* ^{Note 7}	0/1	6/6	-	-	-	-	1/1
Senior Executives							
Mr Nixon L S Chan ^{Note 8}	-	-	13/13	-	-	-	-
Mr Christopher H N Ho	-	-	13/13	-	-	-	-
Mr Donald Y S Lam	-	-	10/13	-	-	-	-
Mr Andrew W L Leung	-	-	12/13	-	-	-	-
Mr Nai Pan Tang	-	-	11/13	-	-	-	-
Mrs Louise Lam ^{Note 9}	-	-	4/5	-	-	-	-
Average Attendance Rate	69%	92%	87%	89%	92%	100%	100%

* INEDs

NEDs

Note 3 Ms L Y Chiang was appointed as member of the Remuneration Committee with effect from the conclusion of the AGM held on 16 May 2013.

Note 4 Ms Anita Y M Fung stepped down from the Board with effect from 31 January 2014.

Note 5 Mr Jenkin Hui retired from the Board and ceased being a member of the Remuneration Committee and Nomination Committee with effect from the conclusion of the AGM held on 16 May 2013.

Note 6 Mrs Dorothy K Y P Sit was appointed as member of the Executive Committee with effect from 22 August 2013 and ceased to be a Director and member of Executive Committee with effect from 1 January 2014.

Note 7 Mr Michael W K Wu was appointed a member of the Nomination Committee with effect from the conclusion of the AGM held on 16 May 2013.

Note 8 Mr Nixon L S Chan was appointed as Executive Director with effect from 31 January 2014.

Note 9 Mrs Louise Lam was appointed as member of the Executive Committee with effect from 26 July 2013.

REMUNERATION OF DIRECTORS, SENIOR MANAGEMENT AND KEY PERSONNEL

The Bank's policy on remuneration is to maintain fair and competitive packages based on business needs and industry practice.

Remuneration of Directors

The level of fees paid to NEDs is determined by reference to factors including Directors' workload and commitments and fees paid by comparable institutions.

As regards Executive Directors, the following factors are considered when determining their remuneration packages :

- business needs;
- general economic situation;
- 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 current scales of Director's fees, and additional fees for Chairmen and members of the non-executive Board Committees, namely, Audit Committee, Risk Committee, Remuneration Committee and Nomination Committee, are set out below:

	Current Fees (HK\$ '000)
Board of Directors	
Chairman	590
Vice-Chairman ^{Note 10}	Nil
Other Directors ^{Note 10}	450
Audit Committee	
Chairman	260
Members	160
Risk Committee	
Chairman	260
Members	160
Members of both Audit Committee and Risk Committee	280
Remuneration Committee/ Nomination Committee	
Chairman	90
Members	60

^{Note 10} In line with the remuneration policy of HSBC Group, no Director's fee is payable to those Directors who are full time employees of the Bank and its subsidiaries.

Information relating to the remuneration of each Director for the year ended 31 December 2013 is set out in Note 15 to the Bank's 2013 Financial Statements.

Remuneration of Senior Management and Key Personnel

There were 10 employees and three employees being classified as Senior Management^{Note 11} and Key Personnel^{Note 12} respectively during the year.

Aggregate amount of remuneration^{Note 13} of the Senior Management and Key Personnel during the year, split into fixed and variable remuneration, is set out below:

Amount (HK\$ '000)	2013 (13 employees)	
	Non-deferred	Deferred
Fixed remuneration		
Cash	37,300	-
Variable remuneration		
Cash	21,849	3,165
Shares	2,110	11,968

Note 11 Senior Management refers to those executives who are either:

- (a) members of the Executive Committee of the Bank, namely, (i) Executive Directors; (ii) senior executives of the Bank at the rank of Band 1; and if not already covered by the aforesaid, (iii) Heads of the Bank's major business lines, namely, Global Banking and Markets, Retail Banking and Wealth Management, and Commercial Banking; (iv) Chief Risk Officer; (v) Chief Financial Officer; (vi) Chief Operating Officer; and (vii) Head of Human Resources; or
- (b) Head(s) of the Bank's principal subsidiary/subsidiaries with offshore operations and with total assets representing more than 5% of the Bank's total assets.

Note 12 Key Personnel refers to those executives other than Senior Management, at the rank of Band 3 or above, who are engaged in trading and dealing activities which involve the assumption of material risk or the taking on of material exposures on behalf of the Bank and its subsidiaries.

Note 13 Remuneration refers to all remuneration payments payable to employees during the year with reference to their tenure as Senior Management and Key Personnel.

Aggregate amount of deferred variable remuneration, split into (a) vested and paid during the year and (b) outstanding and unvested as at 31 December 2013, is set out below:

Amount (HK\$ '000)	Awarded for Performance Year 2013	Awarded for Prior Performance Years
Vested and paid out during 2013		
Cash	-	-
Shares	-	6,195
Outstanding and unvested as at 31 December 2013		
Cash	3,165	-
Shares	11,968	13,058

There was no deferred variable remuneration being reduced through performance adjustments in 2013.

Quantitative information on employees' exposure to implicit (e.g. fluctuations in the value of shares or performance units) and explicit adjustments (e.g. malus, clawbacks or similar reversals or downward revaluations of awards) of deferred remuneration and retained remuneration is set out below:

	Amount (HK\$ '000)
Total amount of outstanding deferred remuneration and retained remuneration exposed to ex post explicit / implicit adjustments	28,191
Total amount of reductions during the year due to:	
- Ex post explicit adjustments	-
- Ex post implicit adjustments	+1,066

No Senior Management or Key Personnel has been awarded or paid guaranteed bonus, new sign-on or severance payment during the year.

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 an annual basis. Reports on financial results, business performance and variances against the approved annual operating plan are submitted to the Board for regular review and monitoring at Board meetings.

Strategic planning cycles are generally from three to five years. The Bank's strategic plan 2013 - 2015 was reviewed and approved by the Board in January 2013. Progress on the implementation of the key initiatives in the strategic plan is reported to and reviewed by the Board on a regular basis.

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

The Directors acknowledge their responsibilities for preparing the accounts of the Bank. As at 31 December 2013, the Directors were 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 Bank's Directors have prepared the financial statements of the Bank on a going-concern basis.

The responsibilities of the external auditor with respect to financial reporting are set out in the Independent Auditor's Report attached to the Bank's 2013 Financial Statements.

Internal Controls

System and Procedures

The Board is responsible for internal control of 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 encounters. Business and functional units are responsible for the assessment of individual types of risk arising under their areas of responsibilities, the management of the risks in accordance with risk management procedures and the reporting on risk management. The Bank maintains an effective risk management framework through the setting up of specialised management committees for the oversight and monitoring of major risk areas and the establishment of risk management departments for relevant functions of the Bank. Relevant risk management reports are submitted to Asset and Liability Management Committee, RMC, Executive Committee and Risk Committee, and ultimately to the Board for monitoring the respective types of risk. The Bank's risk management policies and major control limits are approved by the Board or its delegated committees, and are monitored and reviewed regularly according to established policies and procedures.

More detailed discussion on the policies and procedures for management of each of the major types of risk the Bank encounters is set out in the "Risk Management" and "Capital Management" sections of the "Management Discussion and Analysis" in this Annual Report, and Supplementary Notes to the Bank's 2013 Financial Statements.

Annual Assessment

A review of the effectiveness of the Bank's internal control system covering all material controls, including financial, operational, compliance, and risk management controls, is conducted annually. The review at the end of 2013 was conducted with reference to the COSO (The Committee of Sponsoring Organisations of the Treadway Commission) internal control framework, which assesses the Bank's internal control system against the five elements of control environment, risk assessment, control activities, information and communication, and monitoring. The Bank has also conducted an annual review to assess 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 approach, findings, analysis and results of these annual reviews have been reported to the Audit Committee, Risk Committee and the Board.

Framework for Disclosure of Inside Information

The Bank has put in place a robust framework for the disclosure of inside information in compliance with the Securities and Futures Ordinance. The framework sets out the procedures and internal controls for the handling and dissemination of inside information in a timely manner so as to allow the shareholders, customers, staff and other stakeholders to apprehend the latest position of the Bank and its subsidiaries. The framework and its effectiveness are subject to review on a regular basis according to established procedures.

Internal Audit

The internal audit function provides independent, objective assurance to the Management and the Risk and Audit Committees over the risk management and controls framework, to add value and to improve operations. It also helps the Management accomplish its objectives by bringing a systematic and disciplined approach in the evaluation and improvement of the effectiveness of risk management, control, and governance processes.

The scope of work of internal audit function is to determine whether the framework of risk management, control, and governance processes, as designed and represented by the Management, is adequate and functioning by evaluating the effectiveness of internal controls, risk management and governance processes. To assist in meeting these requirements, internal audit function assesses the design and effectiveness of the primary and secondary controls. It places a degree of reliance on the effectiveness of the work completed by the internal control teams. The outcome is a holistic and timely view of how effectively the material risks within the Bank are being managed.

Opportunities for improving management control, profitability, best practice and the Bank's image may also be identified during audits and will be communicated to the appropriate level of the Management. The Bank's Head of Audit reports to the Chairman and the Audit Committee.

External Auditor

KPMG is the Bank's external auditor. The Audit Committee is responsible for making recommendations to the Board on the appointment, re-appointment, removal and remuneration of the external auditor. The external auditor's independence and objectivity, and the effectiveness of the audit process are also reviewed and monitored by the Audit Committee on a regular basis.

During 2013, fees paid to the Bank's external auditor for audit services amounted to HK\$12m, compared with HK\$12.7m in 2012. For non-audit services, the fees paid to the Bank's external auditor amounted to HK\$7.7m, compared with HK\$7.6m in 2012. In 2013, the significant non-audit service assignments covered by these fees include the following:

Nature of service	Fees paid (HK\$m)
Other assurance services	7.5
Tax services	0.2
	<u>7.7</u>

Audit Committee

The Audit Committee assists the Board in meeting its responsibilities for ensuring effective systems of internal control and compliance relating to financial reporting, and in meeting its financial reporting obligations.

Risk Committee

The Risk Committee assists the Board in meeting its responsibilities for ensuring effective systems of risk management, internal control and compliance (other than that relating to financial reporting), and in meeting its risk governance obligations.

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, subject to compliance with the applicable laws and regulations. Including the two results announcements, around a hundred meetings with analysts and fund managers were held in 2013. In addition, the Bank's Vice-Chairman and Chief Executive, and Chief Financial Officer also made presentations and held group meetings with investors at investor forums.

Further, the Bank's website (www.hangseng.com) offers timely access to the Bank's financial information, announcements/circulars to shareholders and information on the Bank's corporate governance structure and practices. For efficient communication with shareholders and in the interest of environmental preservation, shareholders are encouraged to browse the Bank's corporate communications on the Bank's website, in the place of receiving printed copies of the same.

The AGM provides a useful forum for shareholders to exchange views with the Board. The Bank's Chairman, Executive Directors, Chairmen of the Board Committees and NEDs are available at the AGM to answer questions from shareholders about the business and performance of the Bank. In addition, the Bank's external auditor is also invited to attend the AGM to answer questions about the conduct of the audit, and the preparation and contents of the auditor's report. Separate resolutions are proposed at general meetings for each substantial issue, including the re-election and election (as the case may be) of individual Directors. An explanation of the detailed procedures of conducting a poll will be provided to shareholders at the AGM, to ensure that shareholders are familiar with such procedures.

The Bank's last AGM was held on Thursday, 16 May 2013 at Hang Seng Bank Headquarters, 83 Des Voeux Road Central, Hong Kong. All the resolutions proposed at that meeting were approved by the shareholders by poll voting. Details of the poll results are available under the "Investor Relations" section of the Bank's website at www.hangseng.com.

The next AGM will be held on Friday, 9 May 2014, the notice of which will be sent to shareholders at least 20 clear business days before the said meeting. Shareholders may refer to the section "Corporate Information and Calendar" in this Annual Report for information on other important dates for shareholders in year 2014.

Calling an Extraordinary General Meeting

Shareholder(s) holding not less than five percent of the total voting rights of all the members having a right to vote may request to call an Extraordinary General Meeting of the Bank.

The requisition (a) must state the general nature of the business to be dealt with at the meeting, (b) must be signed by the requisitionist(s), and (c) may either be deposited at the Bank's registered office at 83 Des Voeux Road Central, Hong Kong in hard copy form or sent by email to egmrequisition@hangseng.com. If the resolution is to be proposed as a special resolution, the requisition should include the text of the

resolution and specify the intention to propose the resolution as a special resolution. The requisition may consist of several documents in like form, each signed by one or more requisitionist(s).

The requisition must also state (a) the name(s) of the requisitionist(s), (b) the contact details of the requisitionist(s) and (c) the number of ordinary shares of the Bank held by the requisitionist(s).

The Directors must proceed to convene an Extraordinary General Meeting within 21 days from the date of the receipt of the requisition. Such meeting should be held on a date not more than 28 days after the date on which the notice convening the meeting is given.

If the Directors fail to convene the Extraordinary General Meeting as aforesaid, the requisitionist(s), or any of them representing more than one-half of the total voting rights of all of them, may themselves convene the meeting. Any meeting so convened shall not be held after the expiration of three months from the date of the deposit of the requisition.

A meeting so convened by the requisitionist(s) shall be convened in the same manner, as nearly as possible, as that in which meetings are to be convened by the Directors.

Any reasonable expenses incurred by the requisitionist(s) by reason of the failure of the Directors duly to convene a meeting shall be reimbursed to the requisitionist(s) by the Bank.

The above procedures are in line with the requirements of the new Companies Ordinance (Cap 622, Laws of Hong Kong) which will come into operation on 3 March 2014, and will be posted at the Bank's website in due course.

Putting Forward Proposals at General Meetings

Shareholders representing at least 2.5 percent of the total voting rights of all the members having a right to vote, or, at least 50 shareholders who have a relevant right to vote, may:

- put forward proposal at general meeting;
- circulate to other shareholders written statement with respect to matter to be dealt with or other business to be dealt with at general meeting.

The above procedures are in line with the requirements of the new Companies Ordinance, which will come into operation on 3 March 2014, and will be posted at the Bank's website in due course.

For further details on the shareholder qualifications, and the procedures and timeline, in connection with the above, shareholders are kindly requested to refer to Sections 580 and 615 of the new Companies Ordinance.

Further, a shareholder may propose a person other than a retiring Director of the Bank for election as a Director of the Bank at a general meeting. For such purpose, the shareholder must send to the Bank's registered address (for the attention of the Bank's Company Secretary) a written notice which identifies the candidate and includes a notice in writing by that candidate of his/her willingness to be so elected. Such notice must be sent within a period of not less than seven days commencing no earlier than the day after the despatch of the notice of the meeting appointed for such election and ending no later than seven days prior to the date of such meeting. Procedures for shareholders to propose candidates for election as Directors of the Bank are also available on the website of the Bank (www.hangseng.com). Minor changes will be made to the aforesaid procedures pending adoption of the new Articles of Association of the Bank at the 2014 Annual General Meeting and the relevant information posted on the Bank's website will also be updated in due course.

Putting Enquiries to the Board

Shareholders may send their enquiries requiring the Board's attention to the Bank's Company Secretary at the Bank's registered address. Questions about the procedures for convening or putting forward proposals at an AGM or Extraordinary General Meeting may also be put to the Company Secretary by the same means.

Shareholders Communication Policy

The Bank has established a Shareholders Communication Policy to set out the Bank's processes to provide shareholders and the investment community with ready, equal and timely information on the Bank for them to make informed assessments of the Bank's strategy, operations and financial performance, and to encourage them to take active interest in the Bank. The Policy is available on the Bank's website (www.hangseng.com).

MATERIAL RELATED PARTY TRANSACTIONS AND CONNECTED TRANSACTIONS

Material Related Party Transactions and Contracts of Significance

The Bank's material related party transactions are set out in Note 57 to the 2013 Financial Statements. These transactions include those that the Bank has entered into with its immediate holding company and fellow subsidiary companies in the ordinary course of its interbank activities, including the acceptance and placement of interbank deposits, corresponding banking transactions, off-balance sheet transactions, and the provision of other banking and financial services.

The Bank uses the information technology 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 information technology and certain processing services with fellow subsidiaries on a cost recovery basis. In 2013, the Bank's share of the costs included HK\$205m for system development, HK\$249m for data processing, and HK\$182m 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\$183m and HK\$78m respectively in 2013. Hang Seng Investment Management Limited, a wholly owned subsidiary of the Bank, manages, in the ordinary course of its business, a fund administered by a fellow subsidiary, to which management fee rebates were made. The rebate for 2013 amounted to HK\$89m.

These transactions were entered into by the Bank in the ordinary and usual course of business on normal commercial terms, and in relation to those which constituted connected transactions under the Listing Rules, they also complied with applicable requirements under the Listing Rules. The Bank regards its usage of the information technology services of The Hongkong and Shanghai Banking Corporation Limited (amount of information technology services cost incurred for 2013: HK\$488m) as contracts of significance for 2013.

Continuing Connected Transactions

(a) On 22 June 2010, Hang Seng Insurance Company Limited ("HSIC"), a wholly-owned subsidiary of the Bank, entered into the following agreements, which expired on 21 June 2013:

- (i) a management services agreement ("Previous Management Services Agreement") with HSBC Life (International) Limited ("INHK") for a term of three years commencing from 22 June 2010, pursuant to which INHK, directly or through one or more of its affiliates, provided certain management services to HSIC.

INHK charged HSIC for the provision of the services on a fully absorbed cost basis plus a mark-up of 5%. These charges were determined following negotiation on an arm's length basis and in accordance with the policy of the HSBC Group, which took into account the transfer pricing guidelines of UK and the Organisation for Economic Co-operation and Development ("OECD").

- (ii) an investment management agreement ("Previous Investment Management Agreement") with HSBC Global Asset Management (Hong Kong) Limited ("AMHK") for a term of three years commencing from 22 June 2010, pursuant to which AMHK acted as investment manager in respect of certain of HSIC's assets held from time to time.

HSIC paid, on a quarterly basis, to AMHK a fee of between 0.17% and 0.375% per annum of the mean value of the assets under management, which was determined on an arm's length basis.

Details of the terms of and the caps under the Previous Management Services Agreement and the Previous Investment Management Agreement for the period from 22 June to 31 December 2010, and for the years ended 31 December 2011 and 2012, and for the period from 1 January to 21 June 2013, were announced by the Bank on 22 June 2010.

(b) On 21 June 2013, HSIC entered into the following new agreements:

- (i) a new management services agreement ("New Management Services Agreement") with INHK for another term of three years commencing from 22 June 2013, pursuant to which INHK, directly or through one or more of its affiliates, would provide certain management services to HSIC.

INHK would charge HSIC for the provision of the services on a fully absorbed cost basis plus a mark-up of 5%, which was the same as that under the Previous Management Services Agreement. These charges have been determined following negotiation on an arm's length basis and in accordance with the policy of the HSBC Group, which has taken into account the transfer pricing guidelines of UK and the OECD.

- (ii) a new investment management agreement ("New Investment Management Agreement") with AMHK for another term of three years commencing from 22 June 2013, pursuant to which AMHK would act as investment manager in respect of certain of HSIC's assets held from time to time. AMHK has delegated to HSBC Alternative Investments Limited ("HAIL"), an indirect wholly owned subsidiary of HSBC, the management of part of such assets by way of a bespoke portfolio.

HSIC would pay, on a quarterly basis, to AMHK a fee of between 0.15% and 0.75% per annum of the mean value of the assets under management. HSIC would also pay to HAIL a fee of between 0.5% and 0.9% per annum of the aggregate value of assets under management in a bespoke portfolio together with a performance fee of 10% per annum payable in certain circumstances in respect of the amount by which the return in such portfolio exceeded a benchmark return of 3.5% per annum above 3-month LIBOR. The above fees have been determined on an arm's length basis. Subject to the caps under the New Investment Management Agreement not being exceeded, HSIC and AMHK may subsequently agree to vary the above fees.

Details of the terms of and the caps under the New Management Services Agreement and the New Investment Management Agreement for the period from 22 June to 31 December 2013, and for the years ending 31 December 2014 and 2015, and for the period from 1 January to 21 June 2016, were announced by the Bank on 21 June 2013.

The Directors believed that the New Management Services Agreement would enable HSIC to run at a reasonably low cost structure by leveraging on the shared infrastructure and expertise of INHK. The resulting cost efficiency has contributed to increased competitiveness of HSIC's manufactured products in the market, which the Directors considered to be essential to the future business growth of HSIC.

The New Investment Management Agreement was based on the commercial terms set out in the Previous Investment Management Agreement and the Directors (including the INEDs) believed that these terms should remain in place.

INHK and AMHK are both indirect wholly-owned subsidiaries of HSBC, the ultimate controlling shareholder of the Bank and therefore are connected persons of the Bank. Accordingly, all the aforesaid agreements constituted continuing connected transactions of the Bank. The Bank has complied with the disclosure requirements in accordance with Chapter 14A of the Listing Rules.

For the year ended 31 December 2013, the aggregate amount paid under the Previous and the New Management Services Agreements was HK\$97m, whereas the aggregate amount paid under the Previous and the New Investment Management Agreements was HK\$70m.

In respect of all the aforesaid agreements which constituted the Bank's continuing connected transactions, all the INEDs of the Bank have reviewed the said transactions and confirmed that the said transactions have been entered into:

- (a) in the ordinary and usual course of business of the Bank and its subsidiaries;

- (b) on normal commercial terms; and
- (c) in accordance with the relevant agreements governing the same on terms that are fair and reasonable and in the interests of the Bank and its shareholders as a whole.

Further, the Bank has engaged its external auditor to report on the continuing connected transactions of the Bank and its subsidiaries in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 740 "Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules" issued by the Hong Kong Institute of Certified Public Accountants. The auditor has issued an unqualified letter containing their findings and conclusions in respect of the continuing connected transactions set out in the preceding paragraphs in accordance with Listing Rule 14A.38. A copy of the auditor's letter has been provided by the Bank to The Stock Exchange of Hong Kong Limited.

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 2013, the Bank's total headcount was 9,856, representing an increase of 176, or 1.8%, compared with a year earlier. The total headcount comprised 1,654 executives, 4,496 officers and 3,706 clerical and non-clerical staff. The headcount growth in 2013 was mainly in frontline sales and IT specialists to support the Bank's strategic business development.

Employee Remuneration

The Remuneration Committee oversees the Bank's overall reward strategy and ensures all the reward policies are carefully considered in the context of business objective, people strategy, commercial competitiveness and regulatory guidance during their formulation. The Committee may invite any Director, executive, consultant or other relevant party to provide advice in this respect. The fundamental principles, philosophies and processes are documented in the Bank's remuneration policy.

The Bank adopts a Total Reward Approach. In determining the total remuneration for employees, the Bank will make reference to individual's responsibility, capability and risk profile of the job to ensure an appropriate balance between the fixed pay and variable pay.

Fixed pay is determined by taking into account relevant level and composition of pay in the markets in which the Bank operates. Salaries are reviewed in the context of business performance, individual performance and potential, market practice, internal relativities, risk management requirements and competitiveness compared to peers.

Bank-wide variable pay budgets are formulated in consideration of the Bank's business performance, people strategy and the risk appetite parameters, including operational risk, credit risk, funding/liquidity risk, risk adjusted return and capital strength. This helps to ensure that the variable pay pool is shaped by risk considerations and the Bank's performance is sustainable in the long-term. The ex ante risk adjustment of remuneration within the Bank is achieved in the way that the Risk Committee of the Bank will advise the Board and/or the Remuneration Committee, as appropriate, on the alignment of risk appetite with performance objectives set in the context of variable incentive and on whether any adjustments for risk need to be applied when considering performance objectives and actual performance. In addition, the overall variable pay funding proposal is refined with reference to the advice of Chief Risk Officer and Chief Financial Officer in respect of the Bank's financial position and performance against its Risk Appetite profile.

Variable pay is determined with respect to individual's performance against respective financial and non-financial goals and measures including sales quality, customer satisfaction, values and behaviours, adherence to risk and compliance and the relevant governance criteria. Under such arrangement, the performance and remuneration of control function staff is assessed according to a performance scorecard specific to the functional role they undertake which is independent of the businesses they oversee.

Variable pay consists of deferred and non-deferred components in the forms of cash and share award. The Bank adopts a progressive deferral mechanism with higher deferral rates and different forms of deferral by reference to (a) the employee's seniority, role, responsibilities and the potential risks that their activities may create for the Bank; and (b) their total amount of variable remuneration exceeding the prescribed thresholds. The deferred award has a vesting period of three to five years and is subject to clawback under certain specific circumstances with respect to the awardee's conduct or the Bank's performance.

The principles of the remuneration policy are applicable to the Bank and its subsidiaries, subject to the local legislative requirements and market practices and are proportionate to the scope and complexity of the local business.

Employee Engagement

The Bank continues to build a best place to work by promoting employee engagement and by driving a diversity and inclusive culture.

The Global People Survey has been conducted in 2013 and follow up actions have been taken as a continuous effort to drive employee engagement, business performance and a value-based culture across the Bank. The results showed that the Bank's employee engagement level is well above the external best-in-class, strategies are well communicated and implemented and the corporate values are well embedded in our culture.

Growth and Development

The Bank is committed to ensuring the competence and ethical behaviour of staff members with due regard to the principles set out in HKMA's SPM CG-6 on "Competence and Ethical Behaviour". The Bank has established policies and procedures for monitoring, developing and maintaining the competence levels and ethical behaviour of staff members. These include clear guidance as set out in various policy manuals, robust performance management system and training and development solutions provided on a regular and need basis.

In order to fully develop staff competence and potential, the Bank has a comprehensive induction programme that provides new staff with an understanding of the Bank's history, vision, culture, values and corporate governance. To equip staff members with necessary skills and knowledge to meet future challenges and professional requirements, especially those who are involved in regulated businesses and activities, the Bank offers a wide range of training and development programmes in the areas of sales and relationship management, products, operations, compliance, credit and risk. The Bank also offers Professional Qualifications and Education Award Scheme to support staff members to pursue professional or academic qualifications. On average, our staff members received six days of training in 2013.

The Bank aims to strengthen the leadership pipeline and support the personal growth of staff by providing a broad range of leadership and management development solutions. To ensure sustainability, the Bank has strategy, measures and metrics to plan and manage succession to critical roles, and to facilitate talent feed to the succession pipeline. Line businesses and the Human Resources function are connected to accelerate the development of talents and high potential staff through a mix of on-the-job training, coaching and learning interventions.

In support of the Bank's vision and strategy, a bank-wide staff communication and engagement framework has been launched this year. It aims to deepen staff understanding of and gain acceptance to the Bank strategies, as well as to enable their involvement and engagement throughout the journey. Communication is done by individual businesses and functions to cascade key messages about vision and strategy. A new series of leadership programme is run to help managers lead their teams towards the Bank's new strategy and direction. Action learning projects are also established to solicit collaborative, synergistic efforts to drive key strategic initiatives.

Recruitment and Retention

To support the Bank's strategic business development and for replacement of staff turnover, vigorous recruitment was carried out in 2013, especially for front line sales positions, experienced professionals and specialists.

Young talents are constantly recruited and groomed through well-structured, intensive development programmes. Further, trainee programmes have been provided for jobs in selected functional areas in order to build pipeline for succession. There were also conscious efforts on retention of talents and key staff through review of career advancement opportunities and remuneration package to ensure market competitiveness.

OTHER INFORMATION

Organisational Structure

Under the Bank's current organisational structure, the Bank's businesses and functions are set out as follows:

Businesses

Retail Banking and Wealth Management
Commercial Banking
Global Banking and Markets

Functions

Audit
Communications
Company Secretarial Services
Corporate Sustainability
Financial Control
Human Resources
Legal
Marketing
Risk and Compliance
Strategic Planning and Corporate Development
Technology and Services

Business Principles and Values

The Bank has a set of well-founded business principles and corporate values guiding staff to keep the highest personal standards of integrity as well as to comply with the spirit and letter of all laws and regulations when conducting business. "Courageous Integrity" is the guiding principle whereby every employee has the courage to do the right thing without compromising the ethical standards and integrity, and behaves in a "Dependable, Open and Connected" way in everyday work. The Bank advocates the living of values by all staff, promotes their awareness and commitment, and empowers leaders and managers to drive values behaviour in the workplace.

Code of Conduct

To ensure the Bank operates according to the highest standards of ethical conduct and professional competence, all staff are required to strictly follow the Code of Conduct contained in the Bank's Staff Handbook. With reference to the applicable regulatory guidelines and other industry best practices, the Code sets out ethical standards and values to which all the Bank's staff are required to adhere and covers various legal, regulatory and ethical issues. Topics including but not limited to the prevention of bribery, use of information, insider dealing and personal investment dealing, personal benefits, outside directorships/employment and equal opportunities policy are covered in the Code.

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

Avoidance of Conflicts of Interest

The Bank has set standards and established policies and procedures to manage actual or potential conflicts of interest of its staff. Stringent internal structures have been designed to ensure adequate segregation of duties and avoid conflicts of interest. Staff working in sensitive or high-risk areas are required to adhere to job-specific rules and undergo training regarding avoidance of conflicts of interest in carrying out their duties.

Health and Safety

The Bank has a demonstrated commitment to occupational health and safety (“OH&S”) in the workplace with employee engagement through committees, forums and working groups in the development of an OH&S Policy and Management System. By successfully implementing the certified BS OHSAS 18001:2007-compliant Safety Management System, the Bank marks its achievement to be the first bank world-wide to conform to this internationally acclaimed best practice aiming at reducing the exposure of the Bank’s staff, contractors and customers to OH&S risks associated with its business activities at premises over which it has control.

The Bank provides a range of training and activities to enhance the knowledge of its staff in occupational safety and health, fire safety, manual handling, and office safety. A number of staff have acquired Qualified First Aider status so as to offer prompt assistance to their colleagues and customers in the event of a medical emergency or accident whilst awaiting the arrival of the ambulance. Some Qualified First Aiders have also been trained to operate the Automated External Defibrillators installed in the Bank premises.

The Bank implements a Contingency Plan for Communicable Disease, which sets out the key issues to be addressed and the actions to be taken by various units in response to the occurrence of a serious communicable disease, and the keeping of adequate stock of face masks to cater for the needs of its staff in case of an outbreak of influenza pandemic. Staff have been made aware through the Bank-wide intranet of the importance of personal hygiene and health, and the contingency measures to be adopted, to enable the Bank to continue with its services to the community during an outbreak of a serious communicable disease.

The Bank operates a Staff Recreation Centre at Kowloon Bay with a variety of facilities for health enhancement and leisure activities to foster work life balance among its staff and their family members.

BIOGRAPHICAL DETAILS OF DIRECTORS

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

Aged 62

Joined the Board since August 2007

Other positions held within Hang Seng Group

- ^ **Hang Seng Bank Limited** – Chairman of Nomination Committee; Member of Remuneration Committee

Other major appointments

Justice of the Peace

- ^ **China Resources Power Holdings Company Limited** – Independent Non-executive Director
- ^ **Convenience Retail Asia Limited** – Independent Non-executive Director
- Economic Development Commission of HKSAR Government** – Non-official Member
- Federation of Hong Kong Industries** – Honorary President
- ^ **MTR Corporation Limited** – Non-executive Chairman
- ^ **Swiss Re Limited** – Independent Non-executive Director
- The Hongkong and Shanghai Banking Corporation Limited** – Independent Non-executive Director
- The Tianjin Municipal Committee of the Chinese People's Political Consultative Conference** – Member of Standing Committee
- ^ **The Wharf (Holdings) Limited** – Independent Non-executive Director
- ^ **UGL Limited** – Non-executive Director
- University of Pennsylvania, USA** – Trustee

Past major appointments

- Ascendas China Commercial Fund Management Limited** – Chairman (2011 – 2012)
- ^ **CDC Corporation** – Chairman (1999 – 2011)
- ^ **CDC Software Corporation** – Director (2009 – 2012)
- ^ **China.com Inc** – Chairman (1999 – 2013)
- Executive Council of HKSAR Government** – Member (1997– 2002)
- Executive Council of Hong Kong, then under British Administration** – Member (1992 – 1997)
- Hong Kong Mercantile Exchange Limited** – Independent Non-executive Director (2009 – 2013)
- ^ **HSBC Holdings plc** – Independent Non-executive Director (1998 – 2007)
- HSBC Private Equity (Asia) Limited** – Chairman (1997 – 2010)
- ^ **Inchcape plc** – Independent Non-executive Director (1997 – 2009)
- Independent Commission Against Corruption** – Chairman of Advisory Committee on Corruption (1998 – 2006)
- The APEC Business Advisory Council** – Hong Kong Member (2004 – 2009)
- The Hong Kong/European Union Business Cooperation Committee** – Chairman (2005 – 2012)

Qualification

Doctoral Degree in Economics – University of Pennsylvania, USA

Major awards

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

Ms Rose LEE Wai Mun
Vice-Chairman and Chief Executive

Aged 61

Joined the Board since March 2012

Other positions held within Hang Seng Group

- ^ **Hang Seng Bank Limited** – Chairman of Executive Committee; Member of Nomination Committee
- Hang Seng Bank (China) Limited** – Chairman; Member of Executive Committee
- Hang Seng Indexes Company Limited** – Chairman of Hang Seng Index Advisory Committee
- Hang Seng Insurance Company Limited** – Chairman
Chairman of other subsidiaries in Hang Seng Group

Other major appointments

- Guangdong's Association for Promotion of Cooperation between Guangdong, Hongkong & Macao** – Vice-Chairman of the Finance Professional Committee
- Hang Seng Management College** – Chairman of the Board of Governors
- Hang Seng School of Commerce** – Chairman of the Board of Directors
- Ho Leung Ho Lee Foundation** – Member of Board of Trustees
- Hong Kong Trade Development Council** – Member of the Financial Services Advisory Committee
- ^ **HSBC Holdings plc** - Group General Manager
- ^ **Hutchison Whampoa Limited** – Independent Non-executive Director
- ^ **Swire Pacific Limited** – Independent Non-executive Director
- The Community Chest of Hong Kong** – Board Member; Co-chairman of the Campaign Committee
- The Hongkong and Shanghai Banking Corporation Limited** – Director
- The Hong Kong Institute of Bankers** – Vice President
- The Hong Kong University of Science and Technology** – Member of the Court

Past major appointments

- Bank of Shanghai** – Director (2006 – 2012)
- City University of Hong Kong** – Member of the Advisory Committee of the Centre for Transportation, Trade and Financial Studies (2012 – 2013) (*Note 1*)
- HKSAR Government Education and Manpower Bureau** – Member of the Continuing Education Fund China Business Focus Group (2002 – 2009)
- Hong Kong General Chamber of Commerce** – Vice-Chairman of the China Committee (2006 – 2013)
- Hong Kong Monetary Authority** – Member of the PRC Offshore Financing Consultative Committee (1998 – 2000)
- Hong Kong Shipowners' Association** – Honorary Treasurer; Member of the Executive Committee (2009 – 2013) (*Note 1*)
- Hong Kong Trade Development Council** – Member of the China Trade Advisory Committee (2007 – 2011)
- The Hong Kong Institute of Bankers** – Member of the China Development Committee (2005 – 2007)
- The Hongkong and Shanghai Banking Corporation Limited** – joined Corporate Finance Department of Wardley Limited in 1977, seconded to Area Office China, HSBC in 1979; appointed Deputy Chief Executive, China Business (1994 – 2002), Managing Director of Hongkong Bank China Services Limited (1985 – 2004), Head of Corporate Banking, Hong Kong (2002 – 2004), Head of Corporate and Institutional Banking, Hong Kong (2004 – 2007), Head of Corporate Banking, Hong Kong and China (2007 – 2008), Head of Global Banking, China and Hong Kong (2008 – 2009) and Advisor, China and Hong Kong (2009 – 2012)

Qualification

Bachelor's Degree in Business Administration – The University of Hawaii, USA

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

Aged 70

Joined the Board since August 1995

Other positions held within Hang Seng Group

^ **Hang Seng Bank Limited** – Chairman of Remuneration Committee; Member of Nomination Committee

Other major appointments

Justice of the Peace

^ **Guangdong Investment Limited** – Independent Non-executive Director
Hong Kong Monetary Authority – Member of The Exchange Fund Advisory Committee
Long Win Bus Company Limited – Non-executive Director
^ **RoadShow Holdings Limited** – Chairman and Non-executive Director
^ **Swire Properties Limited** – Independent Non-executive Director
The Community Chest of Hong Kong – Board Member
The Hong Kong University of Science and Technology – Chairman of the Court
The Kowloon Motor Bus Company (1933) Limited – Non-executive Director
^ **Transport International Holdings Limited** – Deputy Chairman and Independent Non-executive Director

Past major appointments

HKSAR Commission on Strategic Development – Non-Official Member (2005 – 2009)
^ **Hong Kong Exchanges and Clearing Limited** – Independent Non-executive Director (2000 – 2003)
Hong Kong Civil Service – Private Secretary to the Governor; Deputy Secretary (General Duties); Director of Information Services; Deputy Chief Secretary; Secretary for Trade and Industry; Secretary for Education and Manpower (1964 – 1978; 1980 – 1993)
Sir Edward Youde Memorial Fund – Chairman of the Council (2007 – 2013)
The Community Chest of Hong Kong – Vice Patron (2004 – 2011)
The Hong Kong Jockey Club – Chairman (2006 – 2010)

Qualifications

Degree of Doctor of Social Sciences (honoris causa) – Lingnan University; The University of Hong Kong; The Hong Kong University of Science and Technology
Degree of Doctor of Business Administration (honoris causa) – International Management Centres
Diploma in Management Studies – The University of Hong Kong
Honours Degree in English Literature – The University of Hong Kong

Major award

Gold Bauhinia Star (1999)

Mr Nixon CHAN Lik Sang

Executive Director and Head of Retail Banking and Wealth Management

Aged 61

Joined the Board since January 2014

Other positions held within Hang Seng Group

^ **Hang Seng Bank Limited** – Head of Retail Banking and Wealth Management; Member of Executive Committee
Hang Seng Indexes Company Limited – Member of Hang Seng Index Advisory Committee
Hang Seng Insurance Company Limited – Director
Director of other subsidiaries in Hang Seng Group

Other major appointments

Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Review Tribunal – Member
Employers' Federation of Hong Kong – Elected Member of General Committee

EPS Company (Hong Kong) Limited – Director
Hang Seng Management College – Governor
Hang Seng School of Commerce – Director
MasterCard Asia/Pacific Advisory Board – Director
Small and Medium Enterprises Committee – Member
TransUnion Limited – Director

Past major appointments

- ^ **Hang Seng Bank Limited** – Head of Corporate and Commercial Banking (2009 – 2011)
The Hongkong and Shanghai Banking Corporation Limited
– Senior Executive, Commercial Banking (2005 – 2009);
Held various senior positions in commercial banking and personal financial services (1993 – 2005)

Qualification

Bachelor's Degree in Business Administration – The University of Hawaii, USA

- * **Dr Marvin CHEUNG Kin Tung** GBS, OBE, JP
Director

Aged 66

Joined the Board since May 2004

Other positions held within Hang Seng Group

- ^ **Hang Seng Bank Limited** – Chairman of Risk Committee; Member of Audit Committee

Other major appointments

Justice of the Peace

Airport Authority Hong Kong – Chairman

Economic Development Commission of HKSAR Government – Non-official Member of the Working Group on Transportation

- ^ **HKR International Limited** – Independent Non-executive Director

- ^ **HSBC Holdings plc** – Independent Non-executive Director; Audit Committee member

Lantau Development Advisory Committee of HKSAR Government – Non-official Member (Note 1)

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

The Open University of Hong Kong – Member of the Court (Note 1)

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

Past major appointments

Barristers Disciplinary Tribunal – Member (1998 – 2012)

Executive Council of HKSAR Government – Non-official Member (2005 – 2012)

- ^ **Hong Kong Exchanges and Clearing Limited** – Independent Non-executive Director (2005 – 2011)

- ^ **Sun Hung Kai Properties Limited** – Independent Non-executive Director (2007 – 2009)

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

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

Qualifications

Fellow – Hong Kong Institute of Certified Public Accountants

Fellow – Institute of Chartered Accountants in England and Wales

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

Major awards

Gold Bauhinia Star (2008)

Silver Bauhinia Star (2000)

Officer of the Most Excellent Order of the British Empire (1993)

* **Ms CHIANG Lai Yuen JP**

Director

Aged 48

Joined the Board since September 2010

Other position held within Hang Seng Group

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

Other major appointments

Justice of the Peace

^ **Chen Hsong Holdings Limited** – Executive Director; Chief Executive Officer
Chen Hsong Investments Limited – Director
China Shenzhen Machinery Association – Vice-President
DIRECTORATE SALARIES AND CONDITIONS OF SERVICE OF HKSAR GOVERNMENT – Member of Standing Committee
Federation of Shenzhen Industries – Vice-Chairman
Hospital Authority – Board Member
The Hong Kong University of Science and Technology – Member of the Court
The Shenzhen Committee of the Chinese People's Political Consultative Conference – Member of Standing Committee
The Toys Manufacturers' Association of Hong Kong – Vice-President

Past major appointments

DISCIPLINED SERVICES SALARIES AND CONDITIONS OF SERVICE OF HKSAR GOVERNMENT – Member of Standing Committee (retired in December 2010)
The Hong Kong University of Science and Technology – Member of the Council (2006 – 2012)
The Open University of Hong Kong – Member of the Council (2006 – 2012)

Qualification

Bachelor Degree of Arts – Wellesley College, USA

Major award

"Young Industrialist Awards of Hong Kong" by the Federation of Hong Kong Industries (2004)

Mr Andrew FUNG Hau Chung JP

Executive Director and Head of Global Banking and Markets

Aged 56

Joined the Board since October 2011

Other positions held within Hang Seng Group

^ **Hang Seng Bank Limited** – Member of Executive Committee
Hang Seng Asset Management Pte Ltd – Director
Hang Seng Bullion Company Limited – Director
Hang Seng Indexes Company Limited – Member of Hang Seng Index Advisory Committee (Note 1)
Hang Seng Insurance Company Limited – Director
Hang Seng Investment Management Limited – Director and General Manager
Hang Seng Investment Services Limited – Director
Hang Seng Life Limited – Director
Hang Seng Securities Limited – Executive Director

Other major appointments

Justice of the Peace

Central Policy Unit of HKSAR Government – Associate Member

HKSAR Government Environment Bureau – Member of Energy Advisory Committee

Hong Kong Institute of Certified Public Accountants – Lay Member of the Council

Hospital Authority – Board Member (Note 1)

Independent Commission on Remuneration for Members of the Executive Council and the Legislature, and Officials under the Political Appointment System of HKSAR Government – Member

- ^ **Industrial Bank Co., Ltd.** – Director; Member of Strategic Committee; Member of Remuneration and Evaluation Committee
Labour Department – Member of the Protection of Wages on Insolvency Fund Board
Securities and Futures Commission – Member of Products Advisory Committee
The Community Chest of Hong Kong – Board member
The Hong Kong Mortgage Corporation Limited – Director
The Liaoning Shenyang Committee of the Chinese People's Political Consultative Conference – Member
Treasury Markets Association – Member of the Executive Board

Past major appointments

Business Facilitation Advisory Committee – Non-official member (2009 – 2013) (*Note 1*)
Central Policy Unit of HKSAR Government – Pan-Pearl River Delta Panel – Member (2011 – 2012)

- ^ **Hang Seng Bank Limited** –
Executive Director and Head of Treasury and Investment (2011 – 2012);
General Manager and Head of Treasury and Investment (2009 – 2011);
General Manager and Head of Investment and Insurance (2008 – 2009);
Deputy General Manager and Head of Investment and Insurance (2006 – 2008)
DBS Bank (Hong Kong) Limited – Managing Director, Advisory Sales, Greater China, Wholesale Banking – Global Financial Markets (2002 – 2006)
^ **Commonwealth Bank of Australia, Hong Kong Branch** – Treasurer and Head of Capital Markets, Asia (1996 – 2002)
Hong Kong Trade Development Council – Member of the Financial Services Advisory Committee (2008 – 2012)
The Federation of Hong Kong Industries – Member of General Committee (2007 – 2013)
The Hongkong and Shanghai Banking Corporation Limited – Head of Hong Kong Dollar Markets (1991 – 1996)
Securities and Futures Commission – Member of Process Review Panel (2006 – 2012)

Qualifications

Bachelor of Arts Degree – The University of Hong Kong
Honorary Fellowship – Lingnan University

- * **Dr HU Ziliu, Fred**
Director

Aged 50

Joined the Board since May 2011

Other position held within Hang Seng Group

- ^ **Hang Seng Bank Limited** – Member of Risk Committee

Other major appointments

- China Huarong Asset Management Company** – Member of the advisory board
China Medical Board – Trustee
National Center for Economic Research at Tsinghua University – Director and Professor
Primavera Capital Limited – Founder and Chairman
^ **SCMP Group Limited** – Independent Non-executive Director
^ **Shanghai Pudong Development Bank Co., Ltd.** – External Supervisor
The Nature Conservancy China Board – Chairman
Yale-China Association – Trustee

Past major appointments

Goldman Sachs Group Inc. – Managing Director (2000 – March 2010); Chairman of Greater China (2008 – March 2010)

HKSAR Commission on Strategic Development – Member (2007 – 2009)

Securities and Futures Commission – Member of Advisory Committee (2009 – 2011)

^ **Shanghai Pudong Development Bank Co., Ltd.** – Independent Director (2002 – 2008)

Qualifications

Master of Arts and Doctor of Philosophy in Economics – Harvard University, USA

Master of Science in Engineering Science – Tsinghua University, PRC

Ms Sarah Catherine LEGG

Director

Aged 46

Joined the Board since February 2011

Other major appointments

The Hongkong and Shanghai Banking Corporation Limited – Chief Financial Officer

HSBC Bank (Taiwan) Limited – Director

HSBC Bank Bahamas Limited – President

^ **HSBC Holdings plc** – Group General Manager (Note 1)

HSBC Markets (Bahamas) Limited – President

HSBC Securities Investments (Asia) Limited – Director

The Hong Kong Association of Banks – Member of the Basel Implementation Committee

The Hong Kong Society for Rehabilitation – Honorary Treasurer

Director of other subsidiaries in HSBC Group

Past major appointments

HSBC Asia Holdings BV – Director (2011 – 2013) (Note 1)

HSBC Bank plc – Head of Product Control, Global Banking and Markets (1999 – 2003)

^ **HSBC Holdings plc** – Senior Manager, Finance Transformation (2003 – 2006)

The Hongkong and Shanghai Banking Corporation Limited – Chief Accounting Officer (2006 – 2010)

Qualifications

Master of Arts – King's College, Cambridge University, UK

Fellow – Chartered Institute of Management Accountants

Fellow – Association of Corporate Treasurers

* **Dr Eric LI Ka Cheung** GBS, OBE, JP

Director

Aged 60

Joined the Board since February 2000

Other positions held within Hang Seng Group

^ **Hang Seng Bank Limited** – Chairman of Audit Committee; Member of Risk Committee

Other major appointments

Justice of the Peace

^ **China Resources Enterprise, Limited** – Independent Non-executive Director; Chairman of Audit Committee

Independent Commission on Remuneration for the Members of the District Councils of HKSAR Government – Chairman

Legal Aid Services Council – Chairman

Li, Tang, Chen & Co, Certified Public Accountants – Senior Partner

Long Win Bus Company Limited – Independent Non-executive Director

^ **RoadShow Holdings Limited** – Independent Non-executive Director; Chairman of Audit Committee

- ^ **SmarTone Telecommunications Holdings Limited** – Independent Non-executive Director; Chairman of Audit Committee
- ^ **Sun Hung Kai Properties Limited** – Independent Non-executive Director; Chairman of Audit Committee
The Hong Kong Jockey Club – Steward
The Hong Kong Institute of Education – Treasurer of the Council
The Kowloon Motor Bus Company (1933) Limited – Independent Non-executive Director; Chairman of Audit Committee
The Presidium of the Election of Deputies of the Hong Kong Special Administrative Region to the Twelfth National People's Congress – Member
The Twelfth National Committee of the Chinese People's Political Consultative Conference – Member
- ^ **Transport International Holdings Limited** – Independent Non-executive Director; Chairman of Audit Committee
- ^ **Wong's International (Holdings) Limited** – Independent Non-executive Director; Chairman of Audit Committee

Past major appointments

- ^ **Bank of Communications Co., Ltd.** – Independent Non-executive Director; Chairman of Audit Committee (2007 – 2013)
HKSAR Commission on Strategic Development – Member (2007 – 2012)
Hong Kong Monetary Authority – Chairman of Process Review Committee (2007 – 2010)
The Financial Reporting Council – Convenor of Financial Reporting Review Committee (2007 – 2013)
The International Federation of Accountants – Board Member (2004 – 2006)
The Legislative Council of Hong Kong – Member (1991 – 2004); Chairman of Public Accounts Committee (1995 – 2004)
Meadville Holdings Limited – Independent Non-executive Director; Chairman of Remuneration Committee (2007 – 2010)

Qualifications

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

Major awards

Gold Bauhinia Star (2003)
Officer of the Most Excellent Order of the British Empire (1996)

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

Aged 65

Joined the Board since February 1999

Other major appointments

- Justice of the Peace**
Airport Authority Hong Kong – Board Member
APEC Business Advisory Council – Hong Kong's Representative
Business and Professionals Federation of Hong Kong – Honorary Life President
Chongqing Municipal Government – Economic Adviser
Council for the Promotion and Development of Yangtze – President
- ^ **Great Eagle Holdings Limited** – Non-executive Director
Shanghai Tongji University; Shanghai University – Advisory Professorship
Shui On Group – Chairman
- ^ **Shui On Land Limited** – Chairman
- ^ **SOCAM Development Limited** – Chairman

The Twelfth National Committee of the Chinese People's Political Consultative Conference – Member
The Hong Kong University of Science and Technology – Honorary Court Chairman

Past major appointments

- ^ **China Telecom Corporation Limited** – Independent Non-executive Director (retired in 2008)
- ^ **New World China Land Limited** – Non-executive Director (retired in 2004)
- ^ **Shui On Land Limited** – Chief Executive Officer (2004 – 2011)

Qualifications

Doctorate in Business Administration (honoris causa) – The Hong Kong University of Science and Technology
Doctor of Business (honoris causa) – The University of New South Wales, Australia

Major awards

“Ernst & Young Entrepreneur Of The Year 2009” in the China Real Estate Sector (2009)
Ernst & Young China Entrepreneur Of The Year 2009 (2009)
Chevalier des Arts et des Lettres by the French Government (2005)
Director of the Year in the category of Listed Company Executive Directors by The Hong Kong Institute of Directors in 2002 (2002)
Businessman of the Year award in the Hong Kong Business Awards 2001 (2001)
Gold Bauhinia Star (1998)
Lifetime Achievement Award for Leadership in Property Sector by the 4th World Chinese Economic Forum (2012)

* **Mr Richard TANG Yat Sun** BBS, JP
Director

Aged 61

Joined the Board since August 1995

Other positions held within Hang Seng Group

- ^ **Hang Seng Bank Limited** – Member of Audit Committee
- ^ **Hang Seng Bank (China) Limited** – Supervisor

Other major appointments

Justice of the Peace
China Overseas Friendship Association – Executive Director-General
Customs and Excise Service Children's Education Trust Fund – Chairman of Investment Advisory Board
Fight Crime Committee – Member
Hong Kong Commercial Broadcasting Company Limited – Director
Hong Kong Institute of Certified Public Accountants – Member of Investigation Panel A
^ **King Fook Holdings Limited** – Vice Chairman
^ **Miramar Hotel & Investment Company, Limited** – Director
Richcom Company Limited – Chairman and Managing Director
Steering Committee of HKSAR Government Scholarship Fund – Member
Tang Shiu Kin and Ho Tim Charitable Fund – Advisor
The Twelfth National Committee of the Chinese People's Political Consultative Conference – Member
^ **Wheelock and Company Limited** – Independent Non-executive Director

Past major appointments

Correctional Services Children's Education Trust – Chairman of Investment Advisory Board (2006 – 2011)
Customs and Excise Service Children's Education Trust Fund Committee – Chairman (2006 – 2012)
Hong Kong Institute of Certified Public Accountants – Member of Disciplinary Panel A (2006 – 2012)

Qualifications

Bachelor of Science Degree in Business Administration – Menlo College, California, USA
Master's Degree in Business Administration – University of Santa Clara, California, USA

Major award

Bronze Bauhinia Star (2000)

Mr Peter WONG Tung Shun JP

Director

Aged 62

Joined the Board since May 2005

Other position held within Hang Seng Group

^ **Hang Seng Bank Limited** – Member of Nomination Committee

Other major appointments

Justice of the Peace

^ **Bank of Communications Co., Ltd.** – Non-executive Director

^ **Cathay Pacific Airways Limited** – Independent Non-executive Director

Chongqing Mayor's International Economic Advisory Council – Member

Economic Development Commission of HKSAR Government – Non-official Member

Hong Kong General Chamber of Commerce – Member of General Committee

Hong Kong Monetary Authority – Member of The Exchange Fund Advisory Committee

HSBC Bank (China) Company Limited – Chairman and Non-executive Director; Chairman of Nomination Committee; Member of Remuneration Committee

HSBC Bank Malaysia Berhad – Chairman and Non-executive Director

^ **HSBC Holdings plc** – Group Managing Director; Member of Group Management Board

International Consultative Conference on the Future Economic Development of Guangdong Province – Economic Advisor to the Governor of Guangdong Province of the People's Republic of China (Note 1)

The Hongkong and Shanghai Banking Corporation Limited – Deputy Chairman and Chief Executive; Executive Director

The Hong Kong Institute of Bankers – President

The Hong Kong Management Association – Fellow

The Eleventh Hubei Provincial Committee of the Chinese People's Political Consultative Conference – Member; Member of Standing Committee

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

Past major appointments

Greater Pearl River Delta Business Council – Member (2006 – 2013)

^ **Hong Kong Exchanges and Clearing Limited** – Member of Risk Management Committee (2010)

Hong Kong Institute for Monetary Research – Member of the Board of Directors (2010 – 2011)

Hong Kong Monetary Authority – Member of Banking Advisory Committee (2005 – 2010)

HSBC Bank Australia Limited – Non-executive Director (2010 – 2011)

HSBC Bank (Vietnam) Ltd – Vice-Chairman and Non-executive Director (2010 – 2012)

International Advisor to the Mayor of Tianjin (2010 – 2013) (Note 1)

^ **Ping An Insurance (Group) Company of China, Ltd.** – Non-executive Director (2006 – 2012)

The Hong Kong Association of Banks – Chairman (2001, 2004, 2006 and 2009)

Qualifications

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

* **Mr Michael WU Wei Kuo**

Director

Aged 43

Joined the Board since September 2010

Other position held within Hang Seng Group

^ **Hang Seng Bank Limited** – Member of Nomination Committee

Other major appointments

Hongkong Caterers Limited – Executive Director and Company Secretary

^ **Hongkong Land Holdings Limited** – Non-executive Director

Maxim's Caterers Limited – Chairman and Managing Director

The Community Chest of Hong Kong – Board Member

The Hong Kong University of Science and Technology – Member of the Council

The University of Hong Kong – Member of the Court

Qualification

Bachelor of Science in Applied Mathematics and Economics – Brown University, USA

Major Awards

"Ernst & Young Entrepreneur of The Year 2012 China" - Category Winner (Services) and Country

Winner (Hong Kong / Macau Regions) (2012)

"Executive Award" of the DHL / SCMP Hong Kong Business Awards (2008)

* Independent Non-executive Directors

Non-executive Directors

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

The following were Directors of the Bank who had resigned or stepped down from the Board before the date of this Annual Report. The Board expressed its gratitude to the following Directors for their wise counsel and contribution during their terms of office.

- Ms Anita FUNG Yuen Mei, who stepped down from the Board with effect from 31 January 2014.
- Mr Jenkin HUI, who retired from the Board with effect from the conclusion of the Bank's Annual General Meeting held on 16 May 2013.
- Mrs Dorothy SIT KWAN Yin Ping, who resigned from the Board with effect from 1 January 2014.

Notes:

- 1 New appointments or cessation of appointments since the date of the Bank's 2013 Interim Report.
- 2 The interests of Directors in shares of the Bank, if any, within the meaning of Part XV of the Securities and Futures Ordinance ("SFO") as at 31 December 2013 are disclosed in the section "Directors' and Alternate Chief Executives' Interests" of the Report of the Directors attached to the Bank's 2013 Annual Report.
- 3 Some Directors (as disclosed in the section "Biographical Details of Directors" of the Bank's 2013 Annual Report) are also Directors of HSBC Holdings plc ("HSBC") and/or its subsidiaries. HSBC, through its wholly owned subsidiaries, has an interest in the shares of the Bank under the provisions of Divisions 2 and 3 of Part XV of the SFO, the details of which are disclosed in the section "Substantial Interests in Share Capital" of the Report of the Directors attached to the Bank's 2013 Annual Report.
- 4 Save as disclosed in the section "Biographical Details of Directors" of the Bank's 2013 Annual Report, the Directors (a) have not held any directorships in other publicly listed companies, whether in Hong Kong or overseas, during the last 3 years; (b) do not hold any other positions in the Bank and its subsidiaries; and (c) do not have any other relationships with any Directors, senior management or substantial or controlling shareholders of the Bank, except that Mr Michael W K Wu's spouse is the niece of Dr Vincent H S Lo, a Non-executive Director of the Bank.

- 5 All Directors (except those Directors who are full time employees of the Bank or its subsidiaries) will receive Directors' fees in the amounts approved from time to time by shareholders at the Annual General Meetings of the Bank. The current amounts of Directors' fees have been determined with reference to market rates, directors' workload and required commitment. A Director will also receive a fee for duties assigned to and services provided by him/her as Chairman or member of various Committees of the Bank. Such fees have been determined with reference to the remuneration policy of the Bank.
- 6 Commencing from 1 January 2008, no Directors' fees will be paid to those Directors who are full time employees of the Bank or its subsidiaries. The salary packages of such Directors have been determined with reference to the remuneration policy of the Bank. Such Directors are also entitled to discretionary bonus.
- 7 The details of the emoluments of the Directors on a named basis are disclosed in Note 15 of the Bank's Financial Statements as contained in the Bank's 2013 Annual Report.
- 8 None of the Directors, except Ms Rose W M Lee, Mr Andrew H C Fung and Mr Nixon L S Chan, has signed service contracts with the Bank. The term of appointment of Non-executive Directors (including Independent Non-executive Directors) is three years except that where a Non-executive Director (or an Independent Non-executive Director) has served on the Board for more than nine years, then his/her term of appointment is one year.
- 9 Biographical details of Directors of the Bank are also available on the website of the Bank (www.hangseng.com).

BIOGRAPHICAL DETAILS OF SENIOR MANAGEMENT

Ms Rose LEE Wai Mun

Vice-Chairman and Chief Executive

(Biographical details are set out on page 119)

Mr Andrew FUNG Hau Chung JP

Executive Director and Head of Global Banking and Markets

(Biographical details are set out on pages 122 and 123)

Mr Nixon CHAN Lik Sang

Executive Director and Head of Retail Banking and Wealth Management

(Biographical details are set out on pages 120 and 121)

Mr Christopher HO Hing Nin

Chief Operating Officer

Aged 61

Joined the Bank since July 2009

Major positions held within Hang Seng Group

Hang Seng Bank Limited – Chief Operating Officer; Member of Executive Committee

Hang Seng Real Estate Management Limited – Director

Hang Seng Security Management Limited – Director

Other major appointment

Education Bureau of HKSAR Government – Member of Banking Industry Training Advisory Committee

Past major positions

The Hongkong and Shanghai Banking Corporation Limited

- Head of Service Delivery Asia Pacific (2009);
Held various senior positions in banking operations and personal financial services (1992 – 2008)

Urban Renewal Authority – Member of Central Oasis Community Advisory Committee (2009 – 2012)

Qualification

MSc in Management Information Systems – Sheffield Hallam University, UK

Mr Donald LAM Yin Shing

Head of Commercial Banking

Aged 50

Joined the Bank since March 2003

Major positions held within Hang Seng Group

Hang Seng Bank Limited – Head of Commercial Banking; Member of Executive Committee

Hang Seng Insurance Company Limited – Director

Past major positions

Hang Seng Bank Limited

- Head of Commercial Banking Relationship Management (2005 – 2006);
Deputy Head of Commercial Banking Relationship Management (2004 – 2005);
Senior Relationship Manager of Commercial Banking Relationship Management Department A (2003 – 2004)

Hang Seng General Insurance (Hong Kong) Company Limited – Director (2008 – 2012)

Playmates Holdings Limited – Executive Director and Chief Financial Officer (2001 – 2003)

The Hongkong and Shanghai Banking Corporation Limited

- Senior Marketing and Planning Manager (1999 – 2001);
Senior Corporate Relationship Manager, Commercial Banking (1997 – 1999);
Held various senior positions in Corporate and Commercial Banking (1987 – 1997)

Qualifications

Associate – The Hong Kong Institute of Bankers

Bachelor of Social Science (1st Class Honor) – The University of Hong Kong

Master of Business Administration – The Chinese University of Hong Kong

Master of Science in e-Commerce – The Chinese University of Hong Kong

Mr Andrew LEUNG Wing Lok

Chief Financial Officer

Aged 51

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

Major positions held within Hang Seng Group

Hang Seng Bank Limited – Chief Financial Officer; Member of Executive Committee

Hang Seng Bank (China) Limited – Director

Hang Seng Insurance Company Limited – Director

Other major appointment

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

Past major positions

Hang Seng Bank Limited

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

Qualifications

Associate – The Hong Kong Institute of Chartered Secretaries

Associate – The Institute of Chartered Secretaries and Administrators

Bachelor of PRC Law – Peking University, PRC

Bachelor of Social Sciences (Major in Management) – The University of Hong Kong

Certified Member – Certified Management Accountants Society of British Columbia, Canada

Fellow – Chartered Association of Certified Accountants

Fellow – Hong Kong Institute of Certified Public Accountants

Master of Science, Data processing – University of Ulster, UK

Master of Science in Electronic Commerce and Internet Computing – The University of Hong Kong

Mr TANG Nai Pan

Chief Risk Officer

Aged 52

Joined the Bank since August 2011

Major positions held within Hang Seng Group

Hang Seng Bank Limited – Chief Risk Officer; Member of Executive Committee

Other major appointment

Yantai Bank Co., Ltd – Director

Past major positions

Shanghai Pudong Development Bank Co., Ltd., Shanghai – General Manager/Advisor, Global Markets and Corporate Treasury (2006 – 2011)

DBS Bank Limited, Singapore – Managing Director, Treasury and Risk Management (2001 – 2006)

Citibank (Hong Kong) Limited – Head of Market Risk, North Asia

The Chinese University of Hong Kong – Assistant Professor in Finance

McGill University, Canada – Assistant Professor in Finance

Qualifications

Bachelor of Arts – University of Minnesota, Minneapolis, USA

Master of Science – University of Chicago, USA

Doctor of Philosophy Candidate in Finance – Kellogg School, Northwestern University, USA

Mrs Louise LAM

Head of Human Resources

Aged 57

Joined the Bank since August 2007

Major positions held within Hang Seng Group

Hang Seng Bank Limited

- Head of Human Resources; Member of Executive Committee

Past major positions

The Hongkong and Shanghai Banking Corporation Limited

- Head of Human Resources Operations, Asia Pacific (2004 – 2007);
Held various senior positions in Human Resources (1990 – 2004)

Government of Ontario, Canada – Senior Consultant, Organisational Development (1987 – 1990)

Chase Manhattan Bank – Vice President, Head of Human Resources (1980 – 1987)

Qualification

Bachelor of Social Sciences in Economics and Management Studies – University of Hong Kong

Mr Gordon LAM Wai Chung

Vice-Chairman and Chief Executive of Hang Seng Bank (China) Limited

Aged 54

Joined the Bank since October 2012

Major positions held within Hang Seng Group

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

Past major positions

Hang Seng Bank (China) Limited

- First Deputy Chief Executive and Head of Network (2012 – 2013);
Deputy Chief Executive, Head of Business Development, Corporate and Commercial Banking (2012)

HSBC Bank (China) Company Limited

- Managing Director and Head of Global Banking (2007 – 2011);
Chief Credit Officer (2003 – 2007)

The Hong Kong Association of Banks – Chairman of Preparatory Committee for Hong Kong Commercial Credit Reference Agency (2003)

The Hongkong and Shanghai Banking Corporation Limited

- Senior Manager, Credit Risk Management, Asia Pacific (1988 – 2003)

China Banking Regulatory Commission Shanghai Office – Leader of the Foreign Bank Basel II Working Committee (2007)

Hong Kong Chamber of Commerce in China – One of Founding members (1993 – 1994)

Qualification

Bachelor of Business Administration – The Chinese University of Hong Kong

Note:

Definition of senior management is set out in the “Corporate Governance and Other Information” section in this Annual Report.

REPORT OF THE DIRECTORS

The Directors have pleasure in presenting their report together with the audited financial statements for the year ended 31 December 2013.

Principal Activities

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

Profits

The consolidated profit of the Bank and its subsidiaries and associates for the year and the particulars of dividends which have been paid or declared are set out on pages 142 and 176 of this Annual Report respectively.

Major Customers

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

Subsidiaries

Particulars of the Bank's principal subsidiaries as at 31 December 2013 are set out in note 34 to the financial statements for the year ended 31 December 2013.

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\$12m. For further details of the Bank's corporate social responsibility activities and expenditures, please refer to the section "Corporate Responsibility" of this Annual Report.

Reserves

Profit attributable to shareholders, before dividends, of HK\$26,678m (2012 restated: HK\$19,327m) has been transferred to reserves. Distributable reserve of the Bank as at 31 December 2013 amounted to HK\$31,788m (2012: HK\$24,773m). Other movements in reserves are set out in the consolidated statement of changes in equity.

Directors

The Directors of the Bank who were in office as at the end of the year were Dr Raymond K F Ch'ien, Ms Rose W M Lee, Dr John C C Chan, Dr Marvin K T Cheung, Ms L Y Chiang, Mr Andrew H C Fung, Ms Anita Y M Fung, Dr Fred Ziliu Hu, Ms Sarah C Legg, Dr Eric K C Li, Dr Vincent H S Lo, Mrs Dorothy K Y P Sit, Mr Richard Y S Tang, Mr Peter T S Wong and Mr Michael W K Wu.

Mr Jenkin Hui retired from the Board with effect from the conclusion of the Bank's 2013 Annual General Meeting ("AGM") held on 16 May 2013.

Mrs Dorothy K Y P Sit retired and resigned from the Board with effect from 1 January 2014 and Ms Anita Y M Fung stepped down from the Board with effect from 31 January 2014.

Mr Nixon L S Chan was appointed Executive Director with effect from 31 January 2014. He will retire under the provisions of the Bank's Articles of Association and, being eligible, offer himself for election at the Bank's 2014 AGM to be held on 9 May 2014.

The Directors retiring by rotation in accordance with the Bank's Articles of Association are Dr Raymond K F Ch'ien, Ms L Y Chiang, Ms Sarah C Legg and Mr Michael W K Wu, who, being eligible, offer themselves for re-election at 2014 AGM.

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

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

Status Of Independent Non-executive Directors

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

Directors' And Alternate Chief Executives' Interests

As at 31 December 2013, 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.

Interests in shares

	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
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Number of ordinary shares of HK\$5 each in the Bank

Director:

Dr John C C Chan	1,000 ⁽¹⁾	-	-	-	1,000	0.00
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Number of ordinary shares of US\$0.50 each in HSBC Holdings plc

Directors:

Dr Raymond K F Ch'ien	57,814	-	-	-	57,814	0.00
Ms Rose W M Lee	160,553	1,458	-	35,062 ⁽⁴⁾	197,073	0.00
Dr John C C Chan	24,605 ⁽¹⁾	-	-	-	24,605	0.00
Mr Andrew H C Fung	59,888	-	-	33,865 ⁽⁴⁾	93,753	0.00
Ms Anita Y M Fung	390,873	-	-	319,412 ⁽⁴⁾	710,285	0.00
Ms Sarah C Legg	85,494	2,688	-	76,399 ⁽⁴⁾	164,581	0.00
Dr Eric K C Li	-	45,424	-	-	45,424	0.00
Mrs Dorothy K Y P Sit	80,853 ⁽²⁾	1,031	-	29,904 ⁽⁴⁾	111,788	0.00
Mr Peter T S Wong	858,922	19,241	-	765,649 ⁽⁴⁾	1,643,812	0.00

Alternate Chief Executives:

Mr Nixon L S Chan	42,882	-	-	22,158 ⁽⁴⁾	65,040	0.00
Mr Christopher H N Ho	100,762	49,053	-	7,356 ⁽⁴⁾	157,171	0.00
Mr Donald Y S Lam	33,619	-	-	19,690 ⁽⁴⁾	53,309	0.00
Mr Andrew W L Leung	6,697	-	-	3,545 ⁽⁴⁾	10,242	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
--	---	---	---	--------------------	--------------------	--

Number of perpetual non-cumulative preference shares of US\$0.01 each in HSBC Holdings plc

Director:

Ms Rose W M Lee	-	-	-	306,075 ⁽³⁾	306,075	0.20
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Interests in debentures of associated corporations of the Bank

Name of debenture	Name of Director	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
8.00% perpetual subordinated capital securities, series 2 issued by HSBC Holdings plc	Ms Rose W M Lee	-	-	-	US\$7,651,875 ⁽³⁾	US\$7,651,875
5% senior notes, due on 30 June 2015 and issued by HSBC Finance Corporation	Ms Anita Y M Fung	US\$3 million	-	-	-	US\$3 million

Notes:

- (1) 1,000 shares in the Bank and 4,371 shares in HSBC Holdings plc were jointly held by Dr John C C Chan and his wife.
- (2) 8,046 shares were jointly held by Mrs Dorothy K Y P Sit and her husband.
- (3) Ms Rose W M Lee was a beneficiary of a trust, which had interests in the total principal amount of US\$7,651,875 of the 8.00% perpetual subordinated capital securities, series 2. These perpetual subordinated capital securities were exchangeable at the option of HSBC Holdings plc to 306,075 perpetual non-cumulative preference shares of US\$0.01 each in HSBC Holdings plc. Ms Lee's interests set out in the table under "Interests in shares" and the table under "Interests in debentures of associated corporations of the Bank" represented the same interests.

- (4) These represented interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans to acquire ordinary shares of US\$0.50 each in HSBC Holdings plc and (ii) conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc under the HSBC Share Plans made in favour of Directors and Alternate Chief Executives, as set against their respective names below:

Options (please refer to the options table below for details)	Conditional awards of shares under the HSBC Share Plans (please refer to the awards table below for further information)	Total
Directors:		
Ms Rose W M Lee	- 35,062	35,062
Mr Andrew H C Fung	4,197 29,668	33,865
Ms Anita Y M Fung	4,197 315,215	319,412
Ms Sarah C Legg	10,267 66,132	76,399
Mrs Dorothy K Y P Sit	- 29,904	29,904
Mr Peter T S Wong	- 765,649	765,649
Alternate Chief Executives:		
Mr Nixon L S Chan	4,533 17,625	22,158
Mr Christopher H N Ho	3,443 3,913	7,356
Mr Donald Y S Lam	11,082 8,608	19,690
Mr Andrew W L Leung	- 3,545	3,545

Options

As at 31 December 2013, 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 2013	Director's/ Alternate Chief Executive's term of office in 2013	Options exercised/ cancelled during the	Exercise price per share	Date granted	Exercisable from	Exercisable until
Directors:						
Mr Andrew H C Fung	<u>4,197</u>	- -	HK\$37.8797	29 Apr 2009	1 Aug 2014	31 Jan 2015
Ms Anita Y M Fung	<u>4,197</u>	- -	HK\$37.8797	29 Apr 2009	1 Aug 2014	31 Jan 2015
Ms Sarah C Legg	- 5,738 4,529	2,295 ⁽¹⁾ - -	£6.0216 £7.2181 £3.3116	2 May 2003 30 Apr 2004 29 Apr 2009	2 May 2006 30 Apr 2009 1 Aug 2014	2 May 2013 30 Apr 2014 31 Jan 2015
	<u>10,267</u>					
Alternate Chief Executives:						
Mr Nixon L S Chan	<u>- 4,533</u>	3,615 ⁽²⁾ -	£6.0216 £7.2181	2 May 2003 30 Apr 2004	2 May 2006 30 Apr 2009	1 May 2013 29 Apr 2014
	<u>4,533</u>					

Options held as at 31 December 2013	Options exercised/ cancelled during the Director's/ Alternate Chief Executive's term of office in 2013	Exercise price per share	Date granted	Exercisable from	Exercisable until
Mr Christopher H N Ho	<u>3,443</u>	-	£7.2181	30 Apr 2004	30 Apr 2009
Mr Donald Y S Lam	<u>6,885</u> <u>4,197</u> <u>11,082</u>	- HK\$37.8797	£7.2181 29 Apr 2009	30 Apr 2009 1 Aug 2014	29 Apr 2014 31 Jan 2015

Notes:

(1) As at the date of exercise, 1 May 2013, the market value per share was £7.0750.

(2) As at the date of exercise, 26 April 2013, the market value per share was £6.9990.

Conditional Awards of Shares

As at 31 December 2013, the interests of the Directors and Alternate Chief Executives in the conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc made in favour of them under the HSBC Share Plans were as follows:

Awards held as at 1 January 2013	Awards made during the Director's/ Alternate Chief Executive's term of office in 2013	Awards released during the Director's/ Alternate Chief Executive's term of office in 2013	Awards held as at 31 December 2013
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Directors:

Ms Rose W M Lee	7,988	33,549	7,988	35,062 ⁽¹⁾
Mr Andrew H C Fung	34,334	11,999	17,945	29,668 ⁽¹⁾
Ms Anita Y M Fung	455,184	154,669	308,243	315,215 ⁽¹⁾
Ms Sarah C Legg	55,439	30,194	22,354	66,132 ⁽¹⁾
Mrs Dorothy K Y P Sit	32,568	12,324	16,277	29,904 ⁽¹⁾
Mr Peter T S Wong	547,165	334,809	149,372	765,649 ⁽¹⁾

Alternate Chief

Executives:

Mr Nixon L S Chan	13,691	9,729	6,555	17,625 ⁽¹⁾
Mr Christopher H N Ho	4,627	1,676	2,559	3,913 ⁽¹⁾
Mr Donald Y S Lam	7,028	4,324	3,115	8,608 ⁽¹⁾
Mr Andrew W L Leung	2,993	1,729	1,328	3,545 ⁽¹⁾

Note:

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

All the interests stated above represent long positions. As at 31 December 2013, 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 2013.

Directors' Interests In Contracts

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

Directors' Interests In Competing Businesses

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

Mr Andrew H C Fung is a Director, a member of Strategic Committee and a member of Remuneration and Evaluation Committee of Industrial Bank Co., Ltd. ("Industrial Bank"), in which the Bank holds a 10.9% stake. Industrial Bank conducts general banking business in mainland China.

Ms Rose W M Lee is a Group General Manager of HSBC Holdings plc and a Director of The Hongkong and Shanghai Banking Corporation Limited.

Ms Sarah C Legg is a Group General Manager of HSBC Holdings plc. She is also the Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited and a Director of various HSBC Group subsidiaries.

Mr Peter T S Wong is a Group Managing Director and a member of Group Management Board of HSBC Holdings plc. He is also the Deputy Chairman, Chief Executive and Executive Director of The Hongkong and Shanghai Banking Corporation Limited; and Chairman and Non-executive Director of HSBC Bank Malaysia Berhad and HSBC Bank (China) Company Limited, which are wholly-owned subsidiaries of The Hongkong and Shanghai Banking Corporation Limited. He is a Non-executive Director of Bank of Communications Co., Ltd.

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 Transaction Control Committee which is responsible for considering all matters concerning audit as well as connected party transactions to be entered into by Industrial Bank as required by the laws of mainland China. The majority of members of Industrial Bank's Audit and Related Party Transaction Control Committee are independent Directors.

The Board of the Bank includes eight Independent Non-executive Directors whose views carry significant weight in the Board's decisions. The Audit Committee and Risk Committee of the Bank, both of which consist of three independent non-executive Directors, meet 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 in the best interests of all shareholders and has put in place adequate mechanisms ensuring that the Directors discharge their duties vis-a-vis all shareholders, including in respect of the Bank's dealings with 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 15 to the financial statements for the year ended 31 December 2013.

Substantial Interests In Share Capital

The register maintained by the Bank pursuant to the SFO recorded that, as at 31 December 2013, 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 wholly-owned subsidiary of HSBC Asia Holdings BV, which is a wholly-owned subsidiary of HSBC Asia Holdings (UK) Limited, which in turn is a wholly-owned subsidiary of HSBC Holdings BV. HSBC Holdings BV is a wholly-owned subsidiary of HSBC Finance (Netherlands), which in turn is a wholly-owned subsidiary of HSBC Holdings plc. Accordingly, The Hongkong and Shanghai Banking Corporation Limited's interests are recorded as the interests of HSBC Asia Holdings BV, HSBC Asia Holdings (UK) Limited, HSBC Holdings BV, HSBC Finance (Netherlands) and HSBC Holdings plc.

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

All the interests stated above represent long positions. As at 31 December 2013, 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

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

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.

Auditor

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

On behalf of the Board

Raymond Ch'ien

Chairman

Hong Kong, 24 February 2014

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2013

(Expressed in millions of Hong Kong dollars)

	note	2013	2012 (restated)
Interest income	4	23,825	21,861
Interest expense	4	(5,221)	(4,915)
Net interest income		18,604	16,946
Fee income		7,329	6,298
Fee expense		(1,442)	(1,212)
Net fee income	5	5,887	5,086
Net trading income	6	2,045	2,063
Net income/(expense) from financial instruments designated at fair value	7	345	376
Dividend income	8	1,014	17
Net earned insurance premiums	9	10,005	10,947
Other operating income	10	1,936	1,181
Total operating income		39,836	36,616
Net insurance claims incurred and movement in policyholders' liabilities	11	(11,774)	(12,235)
Net operating income before loan impairment charges		28,062	24,381
Loan impairment charges	12	(536)	(386)
Net operating income		27,526	23,995
Employee compensation and benefits		(4,432)	(4,256)
General and administrative expenses		(3,796)	(3,375)
Depreciation of premises, plant and equipment		(762)	(762)
Amortisation of intangible assets		(113)	(115)
Operating expenses	13	(9,103)	(8,508)
Impairment loss on intangible assets		(13)	-
Operating profit		18,410	15,487
Gains less losses from financial investments and fixed assets	17	179	(5)
Gain on reclassification of Industrial Bank		8,454	-
Loss on reclassification of Yantai Bank		(297)	-
Gain on disposal of a subsidiary		-	355
Net surplus on property revaluation	18	1,188	776
Share of profits from associates		562	5,381
Profit before tax		28,496	21,994
Tax expense	19	(1,818)	(2,667)
Profit for the year		26,678	19,327
Profit attributable to shareholders		26,678	19,327

(Figures in HK\$)

Earnings per share	21	13.95
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	10.11
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The notes on pages 148 to 264 form part of these financial statements.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December 2013

(Expressed in millions of Hong Kong dollars)

	2013	2012 (restated)
Profit for the year	26,678	19,327
Other comprehensive income		
Items that will be reclassified subsequently to the income statement when specific conditions are met:		
Available-for-sale investment reserve:		
- fair value changes taken to equity:		
-- on debt securities	(913)	380
-- on equity shares	(2,638)	90
- fair value changes transferred to income statement:		
-- on hedged items	689	22
-- on disposal	(1)	(1)
- share of changes in equity of associates:		
-- fair value changes	(1)	459
-- fair value changes transferred to income statement on reclassification of Industrial Bank and Yantai Bank	111	-
- deferred taxes	57	(157)
- exchange difference	851	(1)
Cash flow hedging reserve:		
- fair value changes taken to equity	432	341
- fair value changes transferred to income statement	(445)	(328)
- deferred taxes	2	(2)
Exchange differences on translation of:		
- financial statements of overseas branches, subsidiaries and associates	438	28
- cumulative foreign exchange reserve transferred to income statement on reclassification of Industrial Bank and Yantai Bank	(2,150)	-
- other	2	-
Others	30	(35)
Items that will not be reclassified subsequently to the income statement:		
Premises:		
- unrealised surplus on revaluation of premises	2,103	2,222
- deferred taxes	(337)	(358)
- exchange difference	3	-
Defined benefit plans:		
- actuarial gains on defined benefit plans	778	724
- deferred taxes	(128)	(120)
Share-based payments	(3)	(7)
Other comprehensive income for the year, net of tax	(1,120)	3,257
Total comprehensive income for the year	25,558	22,584
Total comprehensive income for the year attributable to shareholders	25,558	22,584

CONSOLIDATED BALANCE SHEET

at 31 December 2013

(Expressed in millions of Hong Kong dollars)

	note	2013	2012 (restated)
ASSETS			
Cash and balances with banks	26	33,294	20,506
Placings with and advances to banks	27	131,363	140,382
Trading assets	28	31,996	34,399
Financial assets designated at fair value	29	6,987	8,343
Derivative financial instruments	30	6,646	5,179
Loans and advances to customers	31	586,240	536,162
Financial investments	32	282,845	253,408
Interest in associates	35	2,062	24,655
Investment properties	36	10,918	4,860
Premises, plant and equipment	37	21,000	19,262
Intangible assets	38	7,974	6,783
Other assets	39	22,405	23,157
Total assets		1,143,730	1,077,096
LIABILITIES AND EQUITY			
Liabilities			
Current, savings and other deposit accounts	40	824,996	769,147
Deposits from banks		11,826	19,845
Trading liabilities	41	62,117	59,853
Financial liabilities designated at fair value	42	489	464
Derivative financial instruments	30	5,246	4,118
Certificates of deposit and other debt securities in issue	43	8,601	11,291
Other liabilities	44	20,467	21,653
Liabilities to customers under insurance contracts	45	85,844	81,670
Current tax liabilities	46	692	588
Deferred tax liabilities	46	3,850	4,323
Subordinated liabilities	47	11,824	11,821
Total liabilities		1,035,952	984,773
Equity			
Share capital	48	9,559	9,559
Retained profits		78,679	59,683
Other reserves		15,334	19,257
Proposed dividends	22	4,206	3,824
Shareholders' funds		107,778	92,323
Total equity and liabilities		1,143,730	1,077,096

Raymond K F Ch'ien *Chairman*
Rose Lee *Vice-Chairman and Chief Executive*
Eric K C Li *Director*

Andrew W L Leung *Chief Financial Officer*

The notes on pages 148 to 264 form part of these financial statements.

BALANCE SHEET

at 31 December 2013

(Expressed in millions of Hong Kong dollars)

	note	2013	2012 (restated)
ASSETS			
Cash and balances with banks	26	30,009	18,250
Placings with and advances to banks	27	96,788	74,846
Trading assets	28	30,477	31,635
Financial assets designated at fair value	29	-	-
Derivative financial instruments	30	5,837	4,634
Loans and advances to customers	31	519,135	476,734
Amounts due from subsidiaries		23,553	81,143
Financial investments	32	195,524	145,414
Investments in subsidiaries	34	17,918	14,778
Interest in associates	35	-	5,172
Investment properties	36	6,878	2,988
Premises, plant and equipment	37	15,414	14,135
Intangible assets	38	381	406
Other assets	39	14,807	16,813
Total assets		956,721	886,948
LIABILITIES AND EQUITY			
Liabilities			
Current, savings and other deposit accounts	40	774,462	730,533
Deposits from banks		10,012	13,952
Trading liabilities	41	29,914	27,776
Financial liabilities designated at fair value	42	-	-
Derivative financial instruments	30	4,486	3,517
Certificates of deposit and other debt securities in issue	43	8,601	11,291
Amounts due to subsidiaries		14,326	15,282
Other liabilities	44	15,802	17,489
Current tax liabilities	46	662	509
Deferred tax liabilities	46	1,985	1,687
Subordinated liabilities	47	11,824	11,821
Total liabilities		872,074	833,857
Equity			
Share capital	48	9,559	9,559
Retained profits	49	60,267	28,064
Other reserves	49	10,615	11,644
Proposed dividends	22	4,206	3,824
Shareholders' funds		84,647	53,091
Total equity and liabilities		956,721	886,948

The notes on pages 148 to 264 form part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2013

(Expressed in millions of Hong Kong dollars)

	2013	2012
Share capital		
At beginning and end of the year	9,559	9,559
Retained profits (including proposed dividends)		
At beginning of the year	63,507	53,152
Dividends to shareholders		
- dividends approved in respect of the previous year	(3,824)	(3,633)
- dividends declared in respect of the current year	(6,309)	(6,309)
Transfer	2,184	373
Total comprehensive income for the year	27,327	19,924
	82,885	63,507
Other reserves		
Premises revaluation reserve		
At beginning of the year	13,790	12,280
Transfer	(655)	(354)
Total comprehensive income for the year	1,769	1,864
	14,904	13,790
Available-for-sale investment reserve		
At beginning of the year	227	(561)
Transfer	-	(4)
Total comprehensive income for the year	(1,845)	792
	(1,618)	227
Cash flow hedging reserve		
At beginning of the year	17	6
Total comprehensive income for the year	(11)	11
	6	17
Foreign exchange reserve		
At beginning of the year	3,071	3,043
Transfer	(64)	-
Total comprehensive income for the year	(1,712)	28
	1,295	3,071
Other reserves		
At beginning of the year	2,152	2,155
Cost of share-based payment arrangements	30	47
Transfer	(1,465)	(15)
Total comprehensive income for the year	30	(35)
	747	2,152
Total equity		
At beginning of the year	92,323	79,634
Dividends to shareholders	(10,133)	(9,942)
Cost of share-based payment arrangements	30	47
Total comprehensive income for the year	25,558	22,584
	107,778	92,323

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2013

(Expressed in millions of Hong Kong dollars)

	2013	2012 (restated)
	note	
Net cash inflow/(outflow) from operating activities	50(a) 23,102	(7,905)
Cash flows from investing activities		
Dividends received from associates	-	658
Purchase of an interest in an associate	-	(32)
Purchase of available-for-sale investments	(43,174)	(36,218)
Purchase of held-to-maturity debt securities	(1,563)	(747)
Proceeds from sale or redemption of available-for-sale investments	33,488	54,839
Proceeds from redemption of held-to-maturity debt securities	84	573
Net cash inflow from sales of loan portfolio	663	48
Net cash inflow from the sale of a subsidiary	-	1,382
Purchase of premises, plant and equipment and intangible assets	(3,589)	(359)
Proceeds from sale of premises, plant and equipment and assets held for sale	911	87
Interest received from available-for-sale investments	1,525	1,873
Dividends received from available-for-sale investments	1,013	16
Net cash (outflow)/inflow from investing activities	(10,642)	22,120
Cash flows from financing activities		
Dividends paid	(10,133)	(9,942)
Interest paid for subordinated liabilities	(311)	(289)
Issue of subordinated liabilities	-	2,326
Repayment of subordinated liabilities	-	(2,326)
Net cash outflow from financing activities	(10,444)	(10,231)
Increase in cash and cash equivalents	2,016	3,984
Cash and cash equivalents at 1 January		
Effect of foreign exchange rate changes	(2,184)	(1,674)
Cash and cash equivalents at 31 December	50(b) 115,779	115,947

The notes on pages 148 to 264 form part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

year ended 31 December 2013

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

1. Basis of preparation

(a) Compliance with Hong Kong Financial Reporting Standards

The consolidated financial statements comprise the financial statements of Hang Seng Bank Limited ("the Bank") and its subsidiaries ("the Group") made up to 31 December 2013. These financial statements have been prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRS"), the provisions of the Hong Kong Companies Ordinance and accounting principles generally accepted in Hong Kong. HKFRS is a collective term that includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ("HKAS"), and interpretations issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). 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 3.

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 3(e), 3(f) and 3(g));
- derivative financial instruments (see note 3(j));
- investment properties (see note 3(p));
- leasehold land and buildings held for own use, where the value of the land cannot be reliably separated from the value of the building at inception of the lease and the entire lease is therefore classified as a finance lease (see note 3(q)); and
- leasehold land and buildings held for own use, where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years (see note 3(q)).

Standards adopted during the year ended 31 December 2013

On 1 January 2013, the Group adopted the following significant new standards and amendments to standards. The impact of these new standards and amendments are as follow:

- Amendments to HKAS 1 "Presentation of Financial Statements – Presentation of items of other comprehensive income" require grouping of items presented in other comprehensive income on the basis of whether they are potentially reclassifiable to profit or loss subsequently. The Group's presentation of other comprehensive income in the consolidated financial statements has been modified retrospectively.
- HKFRS 10 "Consolidated Financial Statements", HKFRS 11 "Joint Arrangements", HKFRS 12 "Disclosure of Interests in Other Entities", HKAS 27 (2011) "Separate Financial Statements", HKAS 28 (2011) "Investments in Associates and Joint Ventures" and amendments to HKFRS 10, HKFRS 11 and HKFRS 12 "Transition Guidance" ("Consolidation Standards") are required to be applied retrospectively.

Under HKFRS 10, there is one approach for determining consolidation for all entities, based on the concepts of power, variability of returns and their linkage. This replaces the approach which applied to financial statements emphasised legal control or exposure to risks and rewards, depending on the nature of the entity under previous HKAS 27 "Consolidated and Separate Financial Statements" and the Former Standing Interpretations Committee's Interpretation 12 "Consolidation – Special Purpose Entities" (HK-SIC 12) adopted by HKICPA. The Group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns by exercising its power over the entity. Under HKFRS 11, it places more focus on the investors' rights and obligations than on the structure of the arrangement when determining the type of joint arrangement with which the Group is involved and introduces the concept of a joint operation.

In accordance with the Transition Guidance, the Group reviewed the population of investments in entities as at 1 January 2013 to determine whether entities previously consolidated or unconsolidated have been changed their consolidation status as a result of applying the Consolidation Standards. The review result concluded that the effect of applying the Consolidation Standards was immaterial on the Group's consolidated financial statements and no restatements are necessary.

NOTES TO THE FINANCIAL STATEMENTS (continued)

1. Basis of preparation (continued)

(a) Compliance with Hong Kong Financial Reporting Standards (continued)

HKFRS 12 is a comprehensive standard on disclosure requirements for all forms of interests in other entities, including unconsolidated structured entities. The disclosure requirements of HKFRS 12 do not require comparative information to be provided for periods prior to initial application. The application of HKFRS 12 did not have a material effect on the Group's consolidated financial statements.

- HKFRS 13 "Fair Value Measurement" ("HKFRS 13") establishes a single framework for measuring fair value and introduces new requirements for disclosure of fair value measurements. HKFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied.

The Group has adopted HKFRS 13 since 1 January 2013 with fair values measured according to the standard's requirements for both financial instruments and non-financial instruments. In particular, the Group's premises and investment properties were revalued at market value and taken into account the highest and best use of the property (i.e. the property use that is physically possible, legally permissible and financially feasible) from the perspective of market participants.

The disclosure requirements of HKFRS 13 do not require comparative information to be provided for periods prior to initial application. An entity is required to make disclosures for each class of assets and liabilities determined based on the nature, characteristics, and risks of the asset or liability, and the level into which it is categorised within the fair value hierarchy. The Group has provided these disclosures in the notes 36 and 37 to the financial statements.

- The Amendments to HKAS 19 "Employee Benefits" require the replacement of interest cost and expected return on plan assets by a finance cost component comprising the net interest on the net defined benefit liability or asset. This finance cost component is determined by applying the same discount rate used to measure the defined benefit obligation to the net defined benefit liability or asset. The difference between the actual return on plan assets and the return included in the finance cost component in the income statement will be presented in other comprehensive income. The amendments have been applied retrospectively with comparative figures adjusted accordingly.

For the Group

Figures in HK\$m	<u>As reported</u>	<u>Adjustment</u>	<u>Restated</u>
Year ended 31 December 2012			
Consolidated income statement:			
Employee compensation and benefits	(4,137)	(119)	(4,256)
Profit before tax	22,113	(119)	21,994
Tax expense	(2,687)	20	(2,667)
Profit attributable to shareholders	19,426	(99)	19,327
Earnings per share (HK\$)	10.16	(0.05)	10.11
Consolidated statement of comprehensive income:			
Defined benefit plans:			
- actuarial gains on defined benefit plans	605	119	724
- deferred taxes	(100)	(20)	(120)
Other comprehensive income for the year, net of tax	3,158	99	3,257

- Amendments to HKFRS 7 "Disclosures – Offsetting Financial Assets and Financial Liabilities" require disclosure of the effect or potential effects of netting arrangements on the entity's financial position. The amendments require disclosure of recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement. The amendments have been applied retrospectively. The application of these amendments did not have a material effect on the Group's consolidated financial statements.

NOTES TO THE FINANCIAL STATEMENTS (continued)

1. Basis of preparation (continued)

(b) Presentation of information

The following have been included in the audited sections of the "Management Discussion and Analysis":

- Disclosure under HKFRS 4 "Insurance Contracts" and HKFRS 7 "Financial Instruments: Disclosures" concerning the nature and extent of risks relating to insurance contracts and financial instruments on pages 32 to 34.
- Capital disclosures under HKAS 1 "Presentation of Financial Statements" on pages 83 to 88.

In accordance with the Group's policy to provide disclosures that help stakeholders understand the Group's performance, financial position and changes thereto, the information provided in the Notes on the Financial Statements and the Risk disclosures in Management Discussion and Analysis goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements. In particular, the Group provides additional disclosures recommended by the Enhanced Disclosure Task Force ("EDTF") report "Enhancing the Risk Disclosures of Banks" in 2013. The report aims to help financial institutions identify areas in which users had requested additional information about banks' risks, and how these risks relate to performance measurement and reporting. The recommendations for disclosure improvement focused on the principal risks faced by the banking industry, and included disclosures about risk governance, capital adequacy, liquidity, funding, credit risk, market risk and other risks.

(c) Consolidation

The Group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The Group is considered to have power over an entity when it has existing rights that give it the current ability to direct the relevant activities of the entity. For the Group to have power over an entity, it must have the practical ability to exercise those rights. In situations where potential voting rights exist, these are taken into account if the Group has the practical ability to exercise those rights.

Where voting rights are not relevant in deciding whether the Group has power over an entity, the assessment of control is based on all facts and circumstances. The Group may have power over an entity even though it holds less than a majority of the voting rights, if it holds additional rights arising through other contractual arrangements or substantive potential voting rights which give it power.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal, the Group may be deemed to be a principal, and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or a guarantee, and is able to influence the returns of the funds by exercising its power.

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are treated as transactions between equity holders and are reported in equity.

Entities that are controlled by the Group are consolidated from the date the Group gains control until the date the Group loses control of the entities.

The Group performs a reassessment of the consolidation status quarterly and whenever there is a change in the facts and circumstances relevant to determining the control of entities.

All intra-group transactions are eliminated on consolidation.

The consolidated financial statements also include the attributable share of the results and reserves of associates based on the financial statements prepared at dates not earlier than three months prior to 31 December 2013.

NOTES TO THE FINANCIAL STATEMENTS (continued)

1. Basis of preparation (continued)

(d) Future Accounting Developments

The HKICPA has issued a number of amendments and new standards which are not yet effective for the year ended 31 December 2013 and which have not been adopted in the financial statements. Key changes are summarised as follows:

- Amendments to HKAS 32 “Offsetting Financial Assets and Financial Liabilities” issued in December 2011 clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in HKAS 32 “Financial Instruments: Presentation”. The amendments are effective for annual periods beginning on or after 1 January 2014 with early adoption permitted and are required to be applied retrospectively. Based on our initial assessment, we do not expect the amendments to have a material effect on the Group’s consolidated financial statements.
- HKFRS 9 “Financial Instruments” (“HKFRS 9”) was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. In November 2010, the HKICPA issued additions to HKFRS 9 dealing with financial liabilities. Together, these changes represent the first phase in the HKCIPA’s planned replacement of HKAS 39 “Financial Instruments: Recognition and Measurement”. Since the final requirements for classification and measurement are uncertain, it remains impracticable to quantify the effect of the HKFRS 9 as at the date of the publication of these financial statements.

The second phase in the HKFRS 9 project to replace HKAS 39 will address the impairment of financial assets. It is proposed to replace the “incurred loss” approach to the impairment of financial assets carried at amortised cost in HKAS 39 with an “expected credit loss” approach, and require that the “expected credit loss” approach be applied to other categories of financial instrument, including loan commitments and financial guarantees. The final requirements for impairment of financial assets are expected to be published in 2014.

The third phase of the project addresses general hedge accounting. Macro hedging is not included in the HKFRS 9 project and will be considered separately. In December 2013, the HKICPA issued amendments to HKFRS 9 in respect of the general hedge accounting requirements, transition and effective date. The revised hedge accounting requirements are applied prospectively and the Group is currently assessing the impact they may have on the financial statements.

These amendments in all phases of HKFRS 9 (except for changes to the presentation of gains and losses for certain liabilities measured at fair value) must be applied from the same effective date. Given the uncertainties with regard to the final HKFRS 9 requirements for classification and measurement and impairment, the Group remains unable to provide a date by which it will apply HKFRS 9 as a whole and quantify the overall effect of HKFRS 9 as at the date of the publication of these financial statements.

- Amendments to HKAS 39 “Financial Instruments: Recognition and Measurement – Novation of Derivatives and Continuation of Hedge Accounting” issued in July 2013 provided relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument meets certain criteria. The amendments are effective from annual periods on or after 1 January 2014 with early adoption permitted and are required to be applied retrospectively. Based on initial assessment, the Group does not expect the amendments to have material impact on the Group’s consolidated financial statements.
- HK(IFRIC) Interpretation 21 “Levies” has been issued in June 2013 as an interpretation of HKAS 37 “Provision, Contingent Liabilities and Contingent Assets”. The interpretation provides guidance on when a liability to pay a levy imposed by a government should be recognised. It clarifies that the obligating event that gives rise to such liability is the activity that triggers the payment of the levy as identified by the legislation. The interpretation is effective from annual periods on or after 1 January 2014 with early adoption permitted and is required to be applied retrospectively. Based on the initial assessment, the Group does not expect the interpretation to have material impact on the Group’s consolidated financial statements.

2. Critical accounting estimates and judgements in applying accounting policies

The results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of the consolidated financial statements. The principal accounting policies are described in Note 3 on the financial statements.

The accounting policies that are deemed critical to our results and financial position, in terms of the materiality of the items to which the policies are applied and the high degree of judgement involved, including the use of assumptions and estimation, are discussed below.

NOTES TO THE FINANCIAL STATEMENTS (continued)

2. Critical accounting estimates and judgements in applying accounting policies (continued)

(i) Impairment allowances on loans and advances

Application of the Group's methodology for assessing loan impairment, as set out in note 3(d), involves considerable judgement and estimation.

For individually significant loans, judgement is required in determining whether there are indications that an impairment loss may already have been incurred and then estimating the amount and timing of expected cash flows, which form the basis of the impairment loss calculation.

For collectively assessed loans, judgement is involved in selecting and applying the criteria for grouping together loans with similar credit characteristics, as well as the statistical and other models used to estimate the losses incurred for each group of loans in the reporting period. The benchmarking of loss rates, the assessment of the extent to which historical losses are representative of current conditions and the ongoing refinement of modelling methodologies provide a means of identifying changes that may be required, but the process is inherently an estimation.

(ii) Valuation of financial instruments

The Group's accounting policy for valuation of financial instruments is included in note 3(h) and is discussed further within note 58 "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 which are usually governed by the terms of the instrument, but management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt;
- the appropriate discount rate for the instrument which management uses all relevant market information in determining the appropriate spread over the risk-free/benchmark rate used by market participants for the particular instrument; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivatives.

When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure, liquidity, credit rating and other market factors 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 into account of factors such as bid-offer spread, credit profile, model limitation and any other factors market participants would consider in the valuation of that instrument. These adjustments are based on defined policies which are applied consistently across the Group.

When unobservable market data has a significant impact on the valuation of derivatives, the entire initial difference in fair value from the transaction price as 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 comprises 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 and other comprehensive income until the financial asset is sold, when the cumulative change in fair value is charged or credited to the income statement. When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in equity is reclassified from equity to the income statement, reducing the Group's operating profit.

(iii) Impairment of available-for-sale financial assets

Judgment is required in determining whether or not a decline in fair value of an available-for-sale financial investment below its original cost is of such a nature as to constitute impairment, and thus whether an impairment loss needs to be recognised under HKAS 39 "Financial Instruments: Recognition and Measurement" ("HKAS 39").

NOTES TO THE FINANCIAL STATEMENTS (continued)

2. Critical accounting estimates and judgements in applying accounting policies (continued)

(iv) 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.

(v) 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 judgement 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 insurance 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 38(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 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 Management Discussion and Analysis.

(vi) 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.

3. Principal accounting policies

(a) Interest income and expense

Interest income and expense for all 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 instrument 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 excluding future credit losses. The calculation includes all amounts paid or received by the Group that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

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

Fee income is earned from a diverse range of services provided to customers and accounted for as follows:

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue when the services are provided (for example, asset management, portfolio and other management advisory and service fees); and

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(b) Non-interest income (continued)

- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and reported in "Interest income" (see note 3(a)).

(ii) 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 3(j). Gains and losses on foreign exchange trading and other transactions are also reported as "Trading income" except for those gains and losses on translation of foreign currencies recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve in accordance with the accounting policy set out in note 3(w).

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

Net income from financial instruments designated at fair value comprises all gains and losses from changes in the fair value of financial assets and financial 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.

(iv) Dividend income

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for listed equity securities, and usually the date when shareholders have approved the dividend for unlisted equity securities.

(v) 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.

(c) 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 and are derecognised when they are repaid, sold or written off, or substantially all the risks and rewards of ownership transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest rate method, less impairment allowances.

(d) Loan impairment

Losses for impaired loans are promptly recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are assessed either for significant loans individually or for loan portfolios with similar credit risk characteristics collectively.

(i) Individually assessed loans

For all loans that are considered individually significant, the Group assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. The criteria used by the Group to determine that there is such objective evidence include:

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- the probability that the borrower will enter bankruptcy or other financial restructuring;
- a concession granted to the borrower for economic or legal reasons relating to the borrower's financial difficulty that results in the forgiveness or postponement of principal, interest or fees, where the concession is not insignificant; and
- a significant downgrading in credit rating by an external rating agency.

For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(d) Loan impairment (continued)

- 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;
- 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 currency of the loan if not denominated in local currency; and
- where available, the secondary market price for the debt.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate and comparing the resultant present value with the loan's current carrying amount. The impairment allowances on individually significant accounts are reviewed at least quarterly and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and the timing and amount of actual and anticipated receipts. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

(ii) Collectively assessed loans

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

- for homogeneous groups of loans that are not considered individually significant; and
- to cover losses which have been incurred but have not yet been identified as loans subject to individual assessment.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective impairment. This reflects impairment losses that the Group has incurred as a result of events occurring before the balance sheet date, which the Group is not able to identify on an individual loan basis, and that can be reliably estimated. These losses will only be individually identified in the future. As soon as information becomes available which identifies losses on individual loans within the Group, those loans are removed from the Group and assessed on an individual basis for impairment. 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 at the balance sheet date 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. Where loans are secured, this is generally after receipt of any proceeds from the realisation of collateral. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write off may be earlier.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(d) Loan impairment (continued)

(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 excess is written back by reducing the loan impairment allowance account accordingly. The write-back 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" if the carrying amounts of the assets are recovered principally through sale, the assets are available for sale in their present condition and the sale is highly probable. 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.

(vi) Renegotiated loans

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

(e) 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 and the market risk of which is 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 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.

(f) 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 on initial recognition. The Group may designate financial instruments at fair value upon inception when the designation:

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities or recognising the gains and losses on them on different bases.
- applies to a group of financial assets, financial liabilities or both that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to key management personnel. Under this criterion, certain liabilities under investment contracts and financial assets held to meet liabilities under insurance and investment contracts are the main classes of financial instruments so designated.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments and which would otherwise be required to be accounted for separately.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(f) Financial instruments designated at fair value (continued)

This fair value designation, once made, is irrevocable. Financial assets and financial liabilities are recognised when the Group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, the fair values are remeasured and gains and losses from changes therein are recognised in the income statement within 'Net income from financial instruments designated at fair value'.

(g) Financial Investments

Financial instruments intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity.

(i) Available-for-sale financial assets

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

(ii) 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) Valuation of financial instruments

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the Group recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the Group enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the Group's valuation methodologies, which are described in note 58.

(i) Sale and repurchase agreements

Where securities are sold subject to commitment to repurchase them at a pre-determined price ("repo"), 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 ("reverse repo") 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.

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties under these agreements is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(j) Derivative financial instruments and hedge accounting

Derivative financial instruments ("derivatives") are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract; and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are only offset if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains or losses depends on whether the derivative is held for trading, or is designated as a hedging instrument, and if the latter, the nature of the risk being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. The Group designates certain derivatives as either (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ("fair value hedge"); (ii) hedges of highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ("cash flow hedge"). Hedge accounting is applied to derivatives designated as hedging instruments in fair value or cash flow hedge provided certain criteria are met.

Hedge accounting

At the inception of a hedging relationship, the Group documents the relationship between the hedging instruments and the hedged items, its risk management objective and its strategy for undertaking the hedge. The Group also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items.

(i) Fair value hedge

Changes in the fair value of derivatives that are designated and qualified as fair value hedging instruments are recorded in the income statement within "Trading income", along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

If the hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of a hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is released to the income statement immediately.

(ii) Cash flow hedge

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

The accumulated gains and losses recognised in other comprehensive income are recycled to the income statement in the periods in which the hedged item will affect profit or loss.

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

(iii) Hedge effectiveness testing

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

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(j) Derivative financial instruments and hedge accounting (continued)

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted by the Group to assess hedge effectiveness depends 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, 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. Hedge ineffectiveness is recognised in the income statement in "Trading income".

(iv) Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in "Trading income", except where derivatives are managed in conjunction with financial instruments designated at fair value, in which case gains and losses are reported in "Net income from financial instruments designated at fair value".

(k) Derecognition of financial assets and liabilities

Financial assets are derecognised when the rights to receive cash flows from the assets have expired; or where the Group has transferred its contractual rights to receive the cash flows of the financial assets and has transferred substantially all the risks and rewards of ownership; or where both control and substantially all the risks and rewards are not retained. Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged or cancelled or expires.

(l) Offsetting financial assets and financial liabilities

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

(m) 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.

(n) Subsidiaries and associates

The Group classifies investments in entities which it controls as subsidiaries. The Group classifies investments in entities over which it has significant influence, and that are not subsidiaries, as associates.

For the purpose of determining this classification, control is considered when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns by exercising its power over the entity.

Investment in associates is recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in the Group's share of net assets.

Profits on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the respective associates. Losses are also eliminated to the extent of the Group's interest in the associates unless the transaction provides evidence of an impairment of the asset transferred.

The Bank's investments in subsidiaries and associates are stated at cost less any impairment losses. An impairment loss recognised in prior periods shall be reversed through the income statement if, and only if, there has been a change in the estimates used to determine the recoverable amount of the investment since the last impairment loss was recognised.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(n) Subsidiaries and associates (continued)

In order to determine whether an impairment test under HKAS 36 "Impairment of Assets" is required in respect of an interest in an associate, it is necessary to consider the indicators in HKAS 39 "Financial Instruments: Recognition and Measurement". Where the review of the indicators suggests that the interest in an associate may be impaired, the impairment testing requirements of HKAS 36 are applied.

The Group's policy for impairment testing on goodwill arising on acquisition of subsidiaries is included under note 3(o). In the case of an interest in an associate, the entire carrying amount in the consolidated balance sheet is compared to its recoverable amount. If the recoverable amount is less than its carrying amount, an impairment loss is recognised in the Group's consolidated financial statements.

(o) 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. If the Group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business is greater than the cost of acquisition, the excess is recognised immediately in the income statement. Goodwill on acquisitions of associates is included in "Interest in associates" and is not tested separately for impairment.

Goodwill is allocated to cash-generating units ("CGUs") for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the CGU may be impaired, by comparing the recoverable amount of a CGU 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 CGU. If the recoverable amount of the CGU is less than the carrying value, an impairment loss is charged to the income statement. Any write-off in excess of the carrying value of goodwill is limited to the fair value of the individual assets and liabilities of the CGU. Goodwill is stated at cost less any accumulated impairment losses, if any.

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

(ii) Intangible assets include the present value of in-force long-term insurance business ("PVIF"), acquired software licences and capitalised development costs of computer software programmes.

- The PVIF is stated at a valuation determined annually by using the methodology as described in note 3(z).
- Computer software acquired is stated at cost less amortisation and impairment allowances. Amortisation of computer software is charged to the income statement over its estimated 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.

Intangible assets that have an indefinite estimated useful life, except for PVIF, or are not yet ready for use, are tested for impairment annually. Intangible assets that have a finite estimated useful life, except for the PVIF, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected economic life. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

(p) Investment properties

Investment properties are land and/or buildings which are owned or held under a leasehold interest to earn rental income and/or for capital appreciation. Investment properties are stated at fair value with changes in fair value being recognised in the income statement. Fair values are determined by independent professional valuers, primarily on the basis of capitalisation of net incomes with due allowance for outgoings and reversionary income potential. Property interests which are held under operating leases to earn rentals, or for capital appreciation or, both, are classified and accounted for as investment property on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 3(r)) and measured at fair value.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(q) Premises, plant and equipment

(i) Land and buildings

The following land and buildings 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 and impairment losses:

- leasehold land and buildings where the fair value of the land cannot be reliably separated from the value of the building at inception of the lease and the premises are not clearly held under an operating lease; and
- leasehold land and buildings where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years.

Revaluations are performed by professionally qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value 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 land and buildings, and are thereafter taken to other comprehensive income and are accumulated separately in the "Premises revaluation reserve". Deficits arising on revaluation, are firstly set off against any previous revaluation surpluses included in the "Premises revaluation reserve" in respect of the same land and buildings, and are thereafter recognised in the income statement.

Depreciation is calculated to write off the valuation of the land and buildings over their estimated useful lives as follows:

- freehold land is not depreciated;
- leasehold land is depreciated over the unexpired terms of the leases; and
- buildings and improvements thereto are depreciated at the greater of 2 per cent per annum on the straight-line basis or over the unexpired terms of the leases or over the remaining estimated useful lives of the buildings.

On revaluation of the land and buildings, depreciation accumulated during the year will be eliminated. Depreciation charged on revaluation surplus of the land and buildings is transferred from "Premises revaluation reserve" to "Retained profits".

On disposal of the land and buildings, 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 land and buildings disposed of included in the "Premises revaluation reserve" are transferred as movements in reserves to "Retained profits".

(ii) Other plant and equipment

Furniture, plant and other equipment, are 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.

(iii) Interest in leasehold land held for own use under operating lease

The Government of Hong Kong owns all the land in Hong Kong and permits its use under leasehold arrangements. Similar arrangements exist in mainland China. At inception of the lease, where the cost of land is known or can be reliably determined and the term of the lease is less than 50 years, the Group records its interest in leasehold land and land use rights separately as operating leases.

Where the cost of land is known or can be reliably determined and the term of the lease is not less than 50 years, the Group records its interest in leasehold land and land use rights as land and buildings held for own use.

Where the cost of the land is unknown or cannot be reliably determined, and the leasehold land and land use rights are not clearly held under an operating lease, they are accounted for as land and buildings held for own use.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(r) Finance and operating leases

Leases which transfer substantially all the risks and rewards of ownership to the lessees, other than legal title, 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 3(p) & 3(q).

(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 3(d).

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 3(q). Impairment allowances are accounted for in accordance with the accounting policy as set out in note 3(s). 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 as lessors under operating leases, the assets are included in the balance sheet according to their nature and, where applicable. Where the Group is the lessee, the leased assets are not recognised on the balance sheet. Rental revenue arising from operating lease is recognised on a straight-line basis in accordance with the Group's revenue recognition policies as set out in note 3(b)(v).

(s) 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 3(d) and 3(o) respectively.

(i) Held-to-maturity investments

For held-to-maturity investments, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition of these assets) on an individual basis.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement. The reversal of impairment is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years.

(ii) Available-for-sale financial assets

At 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 reclassified from equity to the income statement.

The impairment methodologies for available-for-sale financial assets are set out in more detail below.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(s) Impairment of assets (continued)

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.

Available-for-sale debt security

When assessing available-for-sale debt securities for objective evidence of impairment at the reporting date, the Group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer. These types of specific event and other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.

For an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if there is objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income and accumulated separately in equity. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value.

Available-for-sale equity securities

Objective evidence of impairment for available-for-sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered. A significant or prolonged decline in the fair value of the asset below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the period in which the fair value of the asset has been below its original cost at initial recognition.

For an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and recognised in other comprehensive income and accumulated separately in equity. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent recovery in the fair value of the available-for-sale equity security is recognised in the other comprehensive income and the past impairment loss recognised in the income statement is not reversed.

(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.

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).

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(s) Impairment of assets (continued)

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.

(t) Income tax

Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised in other comprehensive income or directly in equity, in which case the relevant amounts of tax are recognised in other comprehensive income or directly in equity, respectively.

Current tax 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.

(u) 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.

Payments to defined contribution plans and state-managed retirement benefit plans, where the Group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they incur.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(u) Employee benefits (continued)

The costs recognised for funding defined benefit plans are determined using the projected unit credit method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised in shareholders' equity and presented in the statement of comprehensive income in the period they arise. Past service costs are recognised immediately to the extent the benefits are vested, and are otherwise recognised on a straight-line basis over the average period until the benefits are vested. The current service costs and any past service costs together with the expected return on plan assets less the unwinding of the discount on the plan liabilities are charged to "Employee compensation and benefits".

The net defined benefit asset or liability recognised in the balance sheet represents the difference between the fair value of plan assets and the present value of the defined benefit obligations adjusted for unrecognised past service costs. In the case of a defined benefit asset, it is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

(v) 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, is expensed immediately.

Fair value is determined by using market prices or 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.

Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the modified vesting period.

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.

(w) 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. Any resulting exchange differences 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.

The results of branches, subsidiaries and associates not reporting in Hong Kong dollars are translated into Hong Kong dollars at the average rates of exchange for the reporting period. Exchange differences arising from the re-translation of opening foreign currency net investments and the related cost of hedging, if any, and exchange differences arising from re-translation of the result for the year from the average rate to the exchange rate ruling at the year-end, are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(w) Translation of foreign currencies (continued)

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's financial statements. In the consolidated financial statements, these exchange differences are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve. On disposal of a foreign operation, exchange differences relating thereto previously recognised in reserves are recognised in the income statement.

(x) 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 arising from past events and a reliable estimate can be made as to the amount of the obligation. Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or nonoccurrence, of one or more uncertain future events not wholly within the control of the Group; or are present obligations that have arisen from past events but are not recognised because it is not probable that settlement will require the outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

(y) 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.

(z) Insurance contracts

Through its insurance subsidiaries, the Group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the Group accepts significant insurance risk from another party, by agreeing to compensate that party on the occurrence of a specified uncertain future event, is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

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 3(c) to 3(j).

Insurance contracts are accounted for as follows:

Net earned insurance premiums

Premiums for life insurance 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 life insurance reflect the total cost of all claims arising during the year, including policyholder cash dividend payment upon policy anniversary and payments of maturities, surrenders and death claims. 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 value of the relevant underlying funds or indices. Reinsurance recoveries are accounted for in the same period as the related claims.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(z) Insurance contracts (continued)

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.

Present value of in-force long-term insurance business

A value is placed on insurance contracts that are classified as long-term insurance business and in force at the balance sheet date and such value is recognised as an asset. This asset represents the present value of the shareholders' interest in the profits expected to emerge from those contracts.

The present value of the in-force long-term insurance business, referred to as PVIF, is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as future mortality and morbidity, lapse rates, levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. The valuation has also included explicit risk margins for non-economic risks in the projection assumptions, and explicit allowances for financial options and guarantees using stochastic methods. Risk discount rates are set on an active basis with reference to market risk free yields and incorporate the explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments. Movements in the PVIF are included in other operating income on a pre-tax basis. The PVIF is reported under "Intangible assets" in the balance sheet.

Liabilities under insurance contracts

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles. Some insurance contracts may contain discretionary participation features whereby the policyholder is entitled to additional payments whose amount and/or timing is at the discretion of the issuer. The discretionary element of these contracts is included in "Liabilities to customers under insurance contracts".

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all expected cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

(aa) Investment contracts

Customer liabilities under 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". Deposits 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, in "Net fee income".

(ab) Dividends

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

(ac) 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.

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. Principal accounting policies (continued)

(ad) 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 comprise cash and balances with banks maturing within one month, treasury bills and certificates of deposit with less than three months' maturity from the date of acquisition and items in the course of collection from or in transmission to other banks.

(ae) Segment reporting

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

(af) Assets held for sale

Non-current assets held for sale and disposal groups (including both assets and liabilities of the disposal groups) are classified as held for sale when their carrying amounts will be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable. Non-current assets held for sale and disposal groups are measured at the lower of their carrying amount and fair value less costs to sell, except for deferred tax assets, financial assets, investment properties, insurance contracts and assets arising from employee benefits, which are measured in accordance with the accounting policies described above.

Immediately before the initial classification as held for sale, the carrying amounts of the asset (or assets and liabilities in the disposal group) are measured in accordance with applicable HKFRSs. On subsequent remeasurement of a disposal group, the carrying amounts of the assets and liabilities that are not within the scope of the measurement requirements of HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations" are measured in accordance with applicable HKFRSs before the fair value less costs to sell of the disposal group is determined.

Income earned and expenses incurred on assets and liabilities of disposal groups held for sale continue to be recognised in the appropriate line items in the income statement until the transaction is complete.

(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 members of the same group. 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.

NOTES TO THE FINANCIAL STATEMENTS *(continued)*

4 Interest income/interest expense

(a) Interest income

	2013	2012
Interest income arising from:		
- financial assets that are not at fair value through profit and loss	23,613	21,537
- trading assets	153	272
- financial assets designated at fair value	59	52
	<u><u>23,825</u></u>	<u><u>21,861</u></u>

of which:

- interest income from listed investments	1,407	1,426
- interest income from unlisted investments	3,464	3,481
- interest income from impaired financial assets	13	11

(b) Interest expense

	2013	2012
Interest expense arising from:		
- financial liabilities that are not at fair value through profit and loss	3,371	3,375
- trading liabilities	1,850	1,540
- financial liabilities designated at fair value	-	-
	<u><u>5,221</u></u>	<u><u>4,915</u></u>

of which:

- interest expense from debt securities in issue maturing after five years	-	-
- interest expense from customer accounts maturing after five years	-	-
- interest expense from subordinated liabilities	311	289

5 Net fee income

	2013	2012
- stockbroking and related services	1,073	941
- retail investment funds	1,548	1,130
- insurance agency	441	367
- account services	354	353
- private banking service fee	104	93
- remittances	348	301
- cards	2,142	1,865
- credit facilities	370	356
- trade services	585	544
- other	364	348
Fee income	7,329	6,298
Fee expense	<u>(1,442)</u>	<u>(1,212)</u>
	<u><u>5,887</u></u>	<u><u>5,086</u></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	2,304	2,172
- fee income	3,448	3,116
- fee expense	<u>(1,144)</u>	<u>(944)</u>

Net fee income on trust and other fiduciary activities where the Group holds or
invests on behalf of its customers

- fee income	674	618
- fee expense	844	767
	<u>(170)</u>	<u>(149)</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

6 Net trading income

	2013	2012
Dealing profits	2,052	2,122
- foreign exchange	1,964	1,986
- interest rate derivatives	64	28
- debt securities	(35)	15
- equities and other trading	59	93
Net loss from hedging activities	(7)	(59)
- fair value hedges		
-- net loss on hedged items attributable to the hedged risk	(689)	(22)
-- net gain/(loss) on hedging instruments	680	(37)
- cash flow hedges		
-- net hedging gain	2	-
	<u><u>2,045</u></u>	<u><u>2,063</u></u>

7 Net income/(expense) from financial instruments designated at fair value

	2013	2012
Net income/(expense) on assets designated at fair value which back insurance and investment contracts	<u><u>345</u></u>	<u><u>376</u></u>
of which dividend income from:		
- listed investments	81	49
- unlisted investments	1	1
	<u><u>82</u></u>	<u><u>50</u></u>

8 Dividend income

	2013	2012
Dividend income:		
- listed investments	999	3
- unlisted investments	15	14
	<u><u>1,014</u></u>	<u><u>17</u></u>

9 Net earned insurance premiums

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2013				
Gross written premiums	-	11,102	7	11,109
Movement in unearned premiums	-	-	-	-
Gross earned premiums	<u><u>-</u></u>	<u><u>11,102</u></u>	<u><u>7</u></u>	<u><u>11,109</u></u>
Gross written premiums ceded to reinsurers	-	(1,104)	-	(1,104)
Reinsurers' share of movement in unearned premiums	-	-	-	-
Reinsurers' share of gross earned premiums	<u><u>-</u></u>	<u><u>(1,104)</u></u>	<u><u>-</u></u>	<u><u>(1,104)</u></u>
Net earned insurance premiums	<u><u>-</u></u>	<u><u>9,998</u></u>	<u><u>7</u></u>	<u><u>10,005</u></u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

9 Net earned insurance premiums (continued)

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2012				
Gross written premiums	221	11,219	8	11,448
Movement in unearned premiums	7	-	-	7
Gross earned premiums	<u>228</u>	<u>11,219</u>	<u>8</u>	<u>11,455</u>
Gross written premiums ceded to reinsurers	(46)	(453)	-	(499)
Reinsurers' share of movement in unearned premiums	(9)	-	-	(9)
Reinsurers' share of gross earned premiums	<u>(55)</u>	<u>(453)</u>	<u>-</u>	<u>(508)</u>
Net earned insurance premiums	<u>173</u>	<u>10,766</u>	<u>8</u>	<u>10,947</u>

10 Other operating income

	2013	2012
Rental income from investment properties	293	197
Movement in present value of in-force long-term insurance business	1,195	815
Others	448	169
	<u>1,936</u>	<u>1,181</u>

11 Net insurance claims incurred and movement in policyholders' liabilities

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2013				
Claims, benefits and surrenders paid	-	8,803	12	8,815
Movement in provisions	-	4,040	(3)	4,037
Gross claims incurred and movement in policyholders' liabilities	-	12,843	9	12,852
Reinsurers' share of claims, benefits and surrenders paid	-	(42)	-	(42)
Reinsurers' share of movement in provisions	-	(1,036)	-	(1,036)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	-	(1,078)	-	(1,078)
Net insurance claims incurred and movement in policyholders' liabilities	-	<u>11,765</u>	<u>9</u>	<u>11,774</u>
2012				
Claims, benefits and surrenders paid	61	2,465	108	2,634
Movement in provisions	11	10,111	(91)	10,031
Gross claims incurred and movement in policyholders' liabilities	72	12,576	17	12,665
Reinsurers' share of claims, benefits and surrenders paid	(15)	(36)	-	(51)
Reinsurers' share of movement in provisions	(1)	(378)	-	(379)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(16)	(414)	-	(430)
Net insurance claims incurred and movement in policyholders' liabilities	<u>56</u>	<u>12,162</u>	<u>17</u>	<u>12,235</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

12 Loan impairment charges

	Group		Bank	
	2013	2012	2013	2012
Net charge for impairment of loans and advances to customers (note 31(b)):				
Individually assessed impairment allowances:				
- new allowances	(191)	(294)	(122)	(131)
- releases	91	224	47	135
- recoveries	16	13	9	4
	<u>(84)</u>	<u>(57)</u>	<u>(66)</u>	<u>8</u>
Net charge for collectively assessed impairment allowances	<u>(452)</u>	<u>(329)</u>	<u>(476)</u>	<u>(332)</u>
Net charge for loan impairment	<u><u>(536)</u></u>	<u><u>(386)</u></u>	<u><u>(542)</u></u>	<u><u>(324)</u></u>

There was no impairment charge (2012: Nil) provided for available-for-sale debt securities, held-to-maturity debt securities and placings with and advances to banks by the Group and the Bank.

13 Operating expenses

	2013	2012 (restated)
Employee compensation and benefits:		
- salaries and other costs*	3,991	3,800
- retirement benefit costs		
-- defined benefit scheme (note 55(a))	310	359
-- defined contribution scheme (note 55(b))	131	97
	<u>4,432</u>	<u>4,256</u>
General and administrative expenses:		
- rental expenses	645	559
- other premises and equipment	1,098	964
- marketing and advertising expenses	713	617
- other operating expenses	1,340	1,235
	<u>3,796</u>	<u>3,375</u>
Depreciation of premises, plant and equipment (note 37(a))	762	762
Amortisation of intangible assets (note 38(c))	113	115
	<u><u>9,103</u></u>	<u><u>8,508</u></u>
* of which:		
share-based payments (note 56(e))	49	70
Cost efficiency ratio	32.4%	34.9%

Included in operating expenses are minimum lease payments under operating leases of HK\$674 million (2012: HK\$585 million).

NOTES TO THE FINANCIAL STATEMENTS (continued)

14 The emoluments of the five highest paid individuals

(a) The aggregate emoluments

	2013	2012
Salaries, allowances and benefits in kind	21	19
Retirement scheme contributions	1	2
Variable bonuses	<u>26</u>	<u>24</u>
	<u><u>48</u></u>	<u><u>45</u></u>

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

HK\$	2013 Number of Individuals	2012 Number of Individuals
5,000,001 - 5,500,000	1	-
6,000,001 - 6,500,000	-	1
6,500,001 - 7,000,000	-	1
7,000,001 - 7,500,000	1	-
7,500,001 - 8,000,000	1	-
8,500,001 - 9,000,000	1	1
11,000,001 - 11,500,000	-	1
11,500,001 - 12,000,000	-	1
19,000,001 - 19,500,000	<u>1</u>	<u>-</u>
	<u><u>5</u></u>	<u><u>5</u></u>

The emoluments of the five highest paid individuals set out above include the emoluments of three (2012: three) Executive Directors. There are no Non-executive Director included in the table above (2012: one). Their respective directors' emoluments are included in note 15.

NOTES TO THE FINANCIAL STATEMENTS (continued)

15 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 '000	Variable bonus ⁽⁶⁾		Total 2013 '000	Total 2012 '000
				Cash ⁽⁷⁾ '000	Shares ⁽⁷⁾ '000		
Executive Directors							
Ms Rose Lee ⁽¹⁾	-	5,882	364	5,275	7,912	19,433	11,387
Mrs Margaret Leung ⁽¹⁾ (Resigned on 11 May 2012)	-	-	-	-	-	-	10,392
Mrs Dorothy K Y P Sit ^{(1) (3)}	-	5,031	15	2,474	1,060	8,580	8,579 ⁽³⁾
Mr Andrew H C Fung ⁽¹⁾	-	3,424	242	2,600	1,400	7,666	6,924
Non-Executive Directors							
Dr Raymond K F Ch'en ⁽⁴⁾	740	-	-	-	-	740	575
Dr John C C Chan ⁽⁴⁾	600	-	-	-	-	600	480
Dr Marvin K T Cheung ⁽⁴⁾	870	-	-	-	-	870	500
Ms L Y Chiang ⁽⁴⁾	490	-	-	-	-	490	340
Ms Anita Y M Fung ⁽²⁾	450	-	-	-	-	450	340
Dr Fred Zuliu Hu ⁽⁴⁾	610	-	-	-	-	610	340
Mr Jenkin Hui ⁽⁴⁾ (Resigned on 16 May 2013)	238					238	450
Ms Sarah C Legg ⁽²⁾	450	-	-	-	-	450	340
Dr Eric K C Li ⁽⁴⁾	870	-	-	-	-	870	600
Dr Vincent H S Lo	450	-	-	-	-	450	340
Mr Richard Y S Tang ⁽⁴⁾	801	-	-	-	-	801	685
Mr Peter T S Wong ⁽²⁾	510	-	-	-	-	510	390
Mr Michael W K Wu ⁽⁴⁾	490	-	-	-	-	490	340
Past Directors							
	<u>-</u>	<u>-</u>	<u>2,292</u>	<u>-</u>	<u>-</u>	<u>2,292</u>	<u>2,251</u>
	<u>7,569</u>	<u>14,337</u>	<u>2,913</u>	<u>10,349</u>	<u>10,372</u>	<u>45,540</u>	<u>45,253</u>
2012	<u>5,767</u>	<u>15,086</u>	<u>2,994</u>	<u>12,820</u>	<u>8,586</u>		

Notes :

- (1) In line with the HSBC Group's remuneration policy, no Director's fees were paid to those Directors who were full time employees of the Bank or its subsidiaries.
- (2) 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.
- (3) Mrs Dorothy K Y P Sit, previously a Non-Executive Director of the Bank in 2012, was re-designated as an Executive Director with effect from 22 August 2013. For comparable basis, the emoluments received in 2012 was regrouped.
- (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\$2.3million in 2013. The Bank made contributions during 2013 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) The amount of bonus comprises the cash and the estimated purchase cost of the award of HSBC Holdings Restricted Share which is measured according to the Group's accounting policies for share-based payment as set out in note 3(v). The bonus comprises the deferred and non-deferred bonus, details of which are also set out in the section of "remuneration of director, senior management and key personnel" under "Corporate Governance and Other Information". The details are also set out in note 57.
- (7) The bonus - cash portion payable to the above directors was on non-deferred basis except HK\$3.16 million (2012: HK\$2.16 million) payable to Ms Rose Lee which was on deferred basis. The bonus - share portion payable to the above directors was on deferred basis except HK\$2.11 million (2012: HK\$1.44 million) payable to Ms Rose Lee which was on non-deferred basis. The 2012 bonus - cash portion payable to Mrs Margaret Leung was on non-deferred basis except HK\$2.16 million which was on deferred basis. The 2012 bonus - share portion payable to Mrs Margaret Leung was on deferred basis except HK\$1.44 million which was on non-deferred basis.

NOTES TO THE FINANCIAL STATEMENTS (continued)

16 Auditors' remuneration

	Group		Bank	
	2013	2012	2013	2012
Statutory audit services	12	13	8	8
Non-statutory audit services and others	8	8	6	6
	20	21	14	14

17 Gains less losses from financial investments and fixed assets

	2013	2012
Net gains from disposal of available-for-sale equity securities:		
- reclassified from reserve	-	(1)
- net gains arising in the year	-	2
	-	1
Net gains from disposal of available-for-sale debt securities:		
- reclassified from reserve	(3)	-
- net gains arising in the year	4	-
	1	-
Gains less losses on disposal of assets held for sale	177	-
Gains less losses on disposal of loans and advances	5	(4)
Gains less losses on disposal of fixed assets	(4)	(2)
	179	(5)

There were no impairment losses or gains less losses on disposal of held-to-maturity debt securities and financial liabilities measured at amortised cost for 2013 and 2012.

18 Net surplus on property revaluation

	2013	2012
Surplus of revaluation on investment properties	1,058	742
Surplus of revaluation on assets held for sale	133	34
Reversal of revaluation deficit on premises (note 37(a))	(3)	-
	1,188	776

19 Tax expense

(a) Taxation in the consolidated income statement represents:

	2013	2012 (restated)
Current tax - provision for Hong Kong profits tax		
Tax for the year	2,534	2,225
Adjustment in respect of prior years	(14)	(75)
	2,520	2,150
Current tax - taxation outside Hong Kong		
Tax for the year	213	92
Adjustment in respect of prior years	7	(2)
	220	90
Deferred tax (note 46(b))		
Origination and reversal of temporary differences	(922)	427
Total tax expense	1,818	2,667

The current tax provision is based on the estimated assessable profit for 2013, 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 (2012: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

NOTES TO THE FINANCIAL STATEMENTS (continued)

19 Tax expense (continued)

(b) Reconciliation between taxation charge and accounting profit at applicable tax rates:

	2013	2012 (restated)
Profit before tax	<u>28,496</u>	<u>21,994</u>
Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2012: 16.5%)	4,702	3,629
Tax effect of:		
- different tax rates in other countries/areas	(75)	(231)
- non-taxable income and non-deductible expenses	(1,835)	(181)
- share of results of associates	(93)	(888)
- others	(881)	338
Actual charge for taxation	<u>1,818</u>	<u>2,667</u>

20 Profit attributable to shareholders

Of the profit attributable to shareholders, HK\$38,730 million (2012: HK\$12,945 million (restated)) has been dealt with in the financial statements of the Bank.

Reconciliation of the above amount to the Bank's profit for the year:

	2013	2012 (restated)
Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements	38,730	12,945
Dividends declared during the year by subsidiaries from retained profits	2,861	1,080
The Bank's profit for the year	<u>41,591</u>	<u>14,025</u>

21 Earnings per share

The calculation of earnings per share for 2013 is based on earnings of HK\$26,678 million (HK\$19,327 million in 2012 (restated)) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2012).

22 Dividends per share

(a) Dividends attributable to the year:

	2013	2012		
	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	2.20	4,206	2.00	3,824
	<u>5.50</u>	<u>10,515</u>	<u>5.30</u>	<u>10,133</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:

	2013	2012
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK\$2.00 per share (2012: HK\$1.90 per share)	<u>3,824</u>	<u>3,633</u>

23 Segmental analysis

HKFRS 8 requires segmental disclosure to be based on the way that the Group's chief operating decision-maker regards and manages the Group, with the amounts reported for each reportable segment being the measures reported to the Group's chief operating decision-maker for the purpose of assessing segmental performance and making decisions about operating matters. To align with the information reported internally to the Group's senior executive management for the purposes of resources allocation and performance assessment, the Group has presented the following five reportable segments. Consolidation adjustments made in preparing the Group's financial statements and inter-segment elimination of income or expenses upon consolidation are included in the "Inter-segment elimination".

Hong Kong and other businesses segment

- **Retail Banking and Wealth Management** activities offer a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance and wealth management.
- **Corporate and Commercial Banking** activities include the provision of financial services, payments and cash management, international trade finance, insurance, wealth management and tailored financial solutions to corporate and commercial customers.
- **Treasury** activities are mainly the provision of treasury operation services in credit, interest rates, foreign exchange, money markets and securities services. 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, equity shares and subordinated debt funding.

Mainland China business segment

- **Mainland China** business segment comprises the business of Hang Seng Bank (China) Limited and the Bank's share of profits from Mainland associates.

(a) Segmental result

For the purpose of segmental analysis, the allocation of revenue reflects the benefits of capital and other funding resources allocated to the business segments by way of internal capital allocation and fund transfer-pricing mechanisms. Cost allocation is based on the direct costs incurred by the respective business segments and apportionment of management overheads. Bank-owned premises are reported under "Other" segment. When these premises are utilised by Global Businesses, notional rent will be charged to relevant business segments based on the market rate.

NOTES TO THE FINANCIAL STATEMENTS (continued)

23 Segmental analysis (continued)

(a) Segmental result (continued)

	Hong Kong and other businesses					Mainland China business	Inter- segment elimination	Total
	Retail Banking and Wealth Management	Corporate and Commercial Banking	Treasury	Other	Total			
2013								
Net interest income/(expense)	9,959	5,777	1,630	(221)	17,145	1,459	-	18,604
Net fee income/(expense)	3,849	1,802	(6)	144	5,789	98	-	5,887
Net trading income/(loss)	300	505	1,123	(14)	1,914	131	-	2,045
Net income/(expense) from financial instruments designated at fair value	350	(5)	-	-	345	-	-	345
Dividend income	-	7	-	1,007	1,014	-	-	1,014
Net earned insurance premiums	9,925	80	-	-	10,005	-	-	10,005
Other operating income	1,612	39	1	334	1,986	7	(57)	1,936
Total operating income	25,995	8,205	2,748	1,250	38,198	1,695	(57)	39,836
Net insurance claims incurred and movement in policyholders' liabilities	(11,702)	(72)	-	-	(11,774)	-	-	(11,774)
Net operating income before loan impairment charges	14,293	8,133	2,748	1,250	26,424	1,695	(57)	28,062
Loan impairment charges	(482)	(46)	-	-	(528)	(8)	-	(536)
Net operating income	13,811	8,087	2,748	1,250	25,896	1,687	(57)	27,526
Operating expenses*	(5,315)	(1,828)	(308)	(230)	(7,681)	(1,479)	57	(9,103)
Impairment loss on intangible assets	(11)	(2)	-	-	(13)	-	-	(13)
Operating profit	8,485	6,257	2,440	1,020	18,202	208	-	18,410
Gains less losses from financial investments and fixed assets	(1)	4	1	176	180	(1)	-	179
Gain on reclassification of Industrial Bank	-	-	-	-	-	8,454	-	8,454
Loss on reclassification of Yantai Bank	-	-	-	-	-	(297)	-	(297)
Net surplus on property revaluation	-	-	-	1,188	1,188	-	-	1,188
Share of profits from associates	455	2	-	-	457	105	-	562
Profit before tax	8,939	6,263	2,441	2,384	20,027	8,469	-	28,496
Share of profit before tax	31.4%	22.0%	8.6%	8.3%	70.3%	29.7%	-	100.0%
Share of profit before tax as a percentage of Hong Kong and other businesses	44.6%	31.3%	12.2%	11.9%	100.0%			
Operating profit excluding loan impairment charges	8,967	6,303	2,440	1,020	18,730	216	-	18,946
* Depreciation/amortisation included in operating expenses	(49)	(30)	(3)	(695)	(777)	(98)	-	(875)
Total assets	309,758	329,252	308,783	104,027	1,051,820	118,476	(26,566)	1,143,730
Total liabilities	650,309	221,964	57,195	16,924	946,392	108,495	(18,935)	1,035,952
Interest in associates	2,022	10	-	-	2,032	30	-	2,062
Non-current assets acquired during the year	1,734	26	1	3,359	5,120	108	-	5,228

NOTES TO THE FINANCIAL STATEMENTS (continued)

23 Segmental analysis (continued)

(a) Segmental result (continued)

	Hong Kong and other businesses					Mainland China business	Inter-segment elimination	Total
	Retail Banking and Wealth Management	Corporate and Commercial Banking	Treasury	Other	Total			
2012 (restated)								
Net interest income/(expense)	8,761	5,289	1,676	(328)	15,398	1,548	-	16,946
Net fee income/(expense)	3,310	1,566	(28)	141	4,989	97	-	5,086
Net trading income/(loss)	527	446	988	(12)	1,949	114	-	2,063
Net income/(expense) from financial instruments designated at fair value	381	(5)	-	-	376	-	-	376
Dividend income	-	7	-	10	17	-	-	17
Net earned insurance premiums	10,776	171	-	-	10,947	-	-	10,947
Other operating income	948	31	-	239	1,218	15	(52)	1,181
Total operating income	24,703	7,505	2,636	50	34,894	1,774	(52)	36,616
Net insurance claims incurred and movement in policyholders' liabilities	(12,120)	(115)	-	-	(12,235)	-	-	(12,235)
Net operating income before loan impairment charges	12,583	7,390	2,636	50	22,659	1,774	(52)	24,381
Loan impairment (charges)/releases	(375)	51	1	-	(323)	(63)	-	(386)
Net operating income	12,208	7,441	2,637	50	22,336	1,711	(52)	23,995
Operating expenses*	(4,835)	(1,758)	(276)	(316)	(7,185)	(1,375)	52	(8,508)
Operating profit	7,373	5,683	2,361	(266)	15,151	336	-	15,487
Gains less losses from financial investments and fixed assets	-	(3)	-	(1)	(4)	(1)	-	(5)
Gain on disposal of a subsidiary	187	168	-	-	355	-	-	355
Net surplus on property revaluation	-	-	-	776	776	-	-	776
Share of profits from associates	291	2	-	-	293	5,088	-	5,381
Profit before tax	7,851	5,850	2,361	509	16,571	5,423	-	21,994
Share of profit before tax	35.7%	26.6%	10.7%	2.3%	75.3%	24.7%	-	100.0%
Share of profit before tax as a percentage of Hong Kong and other businesses	47.4%	35.3%	14.2%	3.1%	100.0%			
Operating profit excluding loan impairment charges	7,748	5,632	2,360	(266)	15,474	399	-	15,873
* Depreciation/amortisation included in operating expenses	(45)	(26)	(4)	(691)	(766)	(111)	-	(877)
Total assets	292,217	289,667	326,257	63,480	971,621	125,232	(19,757)	1,077,096
Total liabilities	621,266	197,590	47,163	38,295	904,314	95,146	(14,687)	984,773
Interest in associates	1,644	8	-	-	1,652	23,003	-	24,655
Non-current assets acquired during the year	57	27	1	167	252	107	-	359

NOTES TO THE FINANCIAL STATEMENTS (continued)

23 Segmental analysis (continued)

(b) Geographic Information

The geographical regions in this analysis are classified by the location of the principal operations of the subsidiary companies or, in the case of the Bank itself, by the location of the branches responsible for reporting the results or advancing the funds.

	2013	2012 (restated)
Total operating income		
- Hong Kong	37,458	33,682
- Mainland	1,695	1,774
- Americas	600	1,097
- Others	171	144
- Inter-segment elimination	(88)	(81)
	<u>39,836</u>	<u>36,616</u>
Profit before tax		
- Hong Kong	19,343	15,428
- Mainland	8,469	5,423
- Americas	573	1,047
- Others	111	96
	<u>28,496</u>	<u>21,994</u>
Total assets		
- Hong Kong	1,048,106	967,288
- Mainland	118,476	125,232
- Americas	185	61,296
- Others	12,702	11,768
- Inter-segment elimination	(35,739)	(88,488)
	<u>1,143,730</u>	<u>1,077,096</u>
Total liabilities		
- Hong Kong	943,141	901,369
- Mainland	108,495	95,146
- Americas	48	60,129
- Others	12,356	11,523
- Inter-segment elimination	(28,088)	(83,394)
	<u>1,035,952</u>	<u>984,773</u>
Equity		
- Hong Kong	104,965	65,919
- Mainland	9,981	30,086
- Americas	137	1,167
- Others	346	245
- Inter-segment elimination	(7,651)	(5,094)
	<u>107,778</u>	<u>92,323</u>
<i>of which:</i>		
Share capital		
- Hong Kong	9,559	9,559
- Mainland	8,847	6,112
- Americas	18	18
- Others	12	13
- Inter-segment elimination	(8,877)	(6,143)
	<u>9,559</u>	<u>9,559</u>
Interest in associates		
- Hong Kong	2,032	1,652
- Mainland	30	23,003
- Americas	-	-
- Others	-	-
	<u>2,062</u>	<u>24,655</u>
Non-current assets*		
- Hong Kong	38,786	29,872
- Mainland	1,105	1,032
- Americas	-	-
- Others	1	1
	<u>39,892</u>	<u>30,905</u>
Contingent liabilities and commitments		
- Hong Kong	269,197	271,065
- Mainland	34,129	36,587
- Americas	-	-
- Others	3,152	4,180
	<u>306,478</u>	<u>311,832</u>

* Non-current assets consist of properties, plant and equipment, goodwill and other intangible assets.

NOTES TO THE FINANCIAL STATEMENTS (continued)

24 Analysis of assets and liabilities by remaining maturity

The maturity analysis is based on the remaining contractual maturity at the balance sheet date, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

	Group								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2013									
Assets									
Cash and balances with banks	33,294	-	-	-	-	-	-	-	33,294
Placings with and advances to banks	2,645	62,104	58,380	6,206	-	2,028	-	-	131,363
Trading assets	-	-	-	-	-	-	31,996	-	31,996
Financial assets designated at fair value	-	-	5	38	482	287	-	6,175	6,987
Derivative financial instruments	-	-	177	210	372	17	5,870	-	6,646
Loans and advances to customers	10,528	46,148	49,992	117,086	193,905	168,581	-	-	586,240
Financial investments: - available-for-sale investments	-	34,571	50,614	54,039	41,766	2,041	-	28,309	211,340
- held-to-maturity debt securities	-	668	2,075	6,204	25,130	37,428	-	-	71,505
Interest in associates	-	-	-	-	-	-	-	2,062	2,062
Investment properties	-	-	-	-	-	-	-	10,918	10,918
Premises, plant and equipment	-	-	-	-	-	-	-	21,000	21,000
Intangible assets	-	-	-	-	-	-	-	7,974	7,974
Other assets	8,691	5,624	3,808	2,275	1,439	130	-	438	22,405
	55,158	149,115	165,051	186,058	263,094	210,512	37,866	76,876	1,143,730
Liabilities									
Current, savings and other deposit accounts	601,180	113,464	71,154	36,116	3,081	1	-	-	824,996
Deposits from banks	3,868	7,570	388	-	-	-	-	-	11,826
Trading liabilities	-	-	-	-	-	-	62,117	-	62,117
Financial liabilities designated at fair value	2	-	-	-	-	487	-	-	489
Derivative financial instruments	-	15	6	216	362	122	4,525	-	5,246
Certificates of deposit and other debt securities in issue: - certificates of deposit in issue	-	-	-	3,949	4,652	-	-	-	8,601
Other liabilities	5,977	5,240	3,917	2,391	167	71	-	2,704	20,467
Liabilities to customers under insurance contracts	-	-	-	-	-	-	-	85,844	85,844
Current tax liabilities	-	-	-	692	-	-	-	-	692
Deferred tax liabilities	-	-	-	-	-	-	-	3,850	3,850
Subordinated liabilities	-	-	-	-	-	11,824	-	-	11,824
	611,027	126,289	75,465	43,364	8,262	12,505	66,642	92,398	1,035,952

NOTES TO THE FINANCIAL STATEMENTS (continued)

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

	Group								Total		
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity			
of which:											
Certificates of deposit included in:											
- trading assets	-	-	-	-	-	-	-	-	-		
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-		
- available-for-sale investments	-	692	848	2,716	209	-	-	17	4,482		
- held-to-maturity debt securities	-	-	-	110	2,637	2,500	-	-	5,247		
	692	848	2,826	2,846	2,500	2,500	-	17	9,729		
Debt securities included in:											
- trading assets	-	-	-	-	-	-	23,807	-	23,807		
- financial assets designated at fair value	-	-	5	38	482	287	-	-	812		
- available-for-sale investments	-	33,879	49,766	51,323	41,557	2,041	-	296	178,862		
- held-to-maturity debt securities	-	668	2,075	6,094	22,493	34,928	-	-	66,258		
	34,547	51,846	57,455	64,532	37,256	23,807	-	296	269,739		
Certificates of deposit in issue included in:											
- trading liabilities	-	-	-	-	-	-	-	-	-		
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-		
- issue at amortised cost	-	-	-	3,949	4,652	-	-	-	8,601		
	-	-	-	3,949	4,652	-	-	-	8,601		

NOTES TO THE FINANCIAL STATEMENTS (continued)

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

	Group								Total	
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity		
2012 (restated)										
Assets										
Cash and balances with banks	20,506	-	-	-	-	-	-	-	20,506	
Placings with and advances to banks	4,179	73,188	54,329	6,987	-	1,699	-	-	140,382	
Trading assets	-	-	-	-	-	-	34,399	-	34,399	
Financial assets designated at fair value	-	-	-	3,618	213	216	-	4,296	8,343	
Derivative financial instruments	-	2	15	103	219	-	4,840	-	5,179	
Loans and advances to customers	10,414	40,796	44,088	106,540	178,956	155,368	-	-	536,162	
Financial investments: - available-for-sale investments	-	20,606	65,917	41,655	54,538	1,656	-	1,405	185,777	
- held-to-maturity debt securities	-	46	445	5,420	22,841	38,879	-	-	67,631	
Interest in associates	-	-	-	-	-	-	-	24,655	24,655	
Investment properties	-	-	-	-	-	-	-	4,860	4,860	
Premises, plant and equipment	-	-	-	-	-	-	-	19,262	19,262	
Intangible assets	-	-	-	-	-	-	-	6,783	6,783	
Other assets	12,282	4,094	2,892	3,098	209	220	-	362	23,157	
	47,381	138,732	167,686	167,421	256,976	198,038	39,239	61,623	1,077,096	
Liabilities										
Current, savings and other deposit accounts	566,743	102,915	64,682	33,919	888	-	-	-	769,147	
Deposits from banks	3,369	13,982	2,491	3	-	-	-	-	19,845	
Trading liabilities	-	-	-	-	-	-	59,853	-	59,853	
Financial liabilities designated at fair value	1	-	-	-	-	463	-	-	464	
Derivative financial instruments	-	-	20	30	1,053	252	2,763	-	4,118	
Certificates of deposit and other debt securities in issue: - certificates of deposit in issue	-	-	-	7,353	3,938	-	-	-	11,291	
Other liabilities	7,745	4,627	2,592	2,960	55	18	-	3,656	21,653	
Liabilities to customers under insurance contracts	-	-	-	-	-	-	-	81,670	81,670	
Current tax liabilities	-	-	-	588	-	-	-	-	588	
Deferred tax liabilities	-	-	-	-	-	-	-	4,323	4,323	
Subordinated liabilities	-	-	-	-	-	11,821	-	-	11,821	
	577,858	121,524	69,785	44,853	5,934	12,554	62,616	89,649	984,773	

NOTES TO THE FINANCIAL STATEMENTS (continued)

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

	Repayable on demand	One month or less but not on demand	Group					No contractual maturity	Total				
			Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading						
of which:													
Certificates of deposit included in:													
- trading assets	-	-	-	-	-	-	400	-	400				
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-				
- available-for-sale investments	-	380	2,758	3,408	668	-	-	36	7,250				
- held-to-maturity debt securities	-	3	-	189	790	2,996	-	-	3,978				
	<u>-</u>	<u>383</u>	<u>2,758</u>	<u>3,597</u>	<u>1,458</u>	<u>2,996</u>	<u>400</u>	<u>36</u>	<u>11,628</u>				
Debt securities included in:													
- trading assets	-	-	-	-	-	-	32,914	-	32,914				
- financial assets designated at fair value	-	-	-	3,618	213	216	-	-	4,047				
- available-for-sale investments	-	20,226	63,159	38,248	53,869	1,656	-	1,035	178,193				
- held-to-maturity debt securities	-	43	445	5,231	22,051	35,883	-	-	63,653				
	<u>-</u>	<u>20,269</u>	<u>63,604</u>	<u>47,097</u>	<u>76,133</u>	<u>37,755</u>	<u>32,914</u>	<u>1,035</u>	<u>278,807</u>				
Certificates of deposit in issue included in:													
- trading liabilities	-	-	-	-	-	-	-	-	-				
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-				
- issue at amortised cost	-	-	-	7,353	3,938	-	-	-	11,291				
	<u>-</u>	<u>-</u>	<u>-</u>	<u>7,353</u>	<u>3,938</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>11,291</u>				

NOTES TO THE FINANCIAL STATEMENTS (continued)

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

	Bank								No contractual maturity	Total	
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading				
2013											
Assets											
Cash and balances with banks	30,009	-	-	-	-	-	-	-	-	30,009	
Placings with and advances to banks	-	38,286	54,853	3,649	-	-	-	-	-	96,788	
Trading assets	-	-	-	-	-	-	30,477	-	-	30,477	
Derivative financial instruments	-	-	177	210	372	17	5,061	-	-	5,837	
Loans and advances to customers	10,564	41,779	40,611	98,951	172,619	154,611	-	-	-	519,135	
Amounts due from subsidiaries	726	1,884	5,973	7,096	7,530	344	-	-	-	23,553	
Financial investments:											
- available-for-sale investments	-	34,444	49,156	49,108	32,749	2,041	-	28,026	195,524		
Investments in subsidiaries	-	-	-	-	-	-	-	17,918	17,918		
Interest in associates	-	-	-	-	-	-	-	-	-	-	
Investment properties	-	-	-	-	-	-	-	6,878	6,878		
Premises, plant and equipment	-	-	-	-	-	-	-	15,414	15,414		
Intangible assets	-	-	-	-	-	-	-	381	381		
Other assets	8,582	3,367	1,943	754	1	120	-	40	14,807		
	49,881	119,760	152,713	159,768	213,271	157,133	35,538	68,657	956,721		
Liabilities											
Current, savings and other deposit accounts	585,612	106,649	61,120	21,022	59	-	-	-	-	774,462	
Deposits from banks	3,868	6,144	-	-	-	-	-	-	-	10,012	
Trading liabilities	-	-	-	-	-	-	29,914	-	-	29,914	
Derivative financial instruments	-	15	6	216	362	122	3,765	-	-	4,486	
Certificates of deposit and other debt securities in issue:											
- certificates of deposit in issue	-	-	-	3,949	4,652	-	-	-	-	8,601	
Amounts due to subsidiaries	3,400	10,914	12	-	-	-	-	-	-	14,326	
Other liabilities	5,891	3,756	2,164	1,230	100	71	-	2,590	15,802		
Current tax liabilities	-	-	-	662	-	-	-	-	-	662	
Deferred tax liabilities	-	-	-	-	-	-	-	1,985	1,985		
Subordinated liabilities	-	-	-	-	-	11,824	-	-	-	11,824	
	598,771	127,478	63,302	27,079	5,173	12,017	33,679	4,575	872,074		

NOTES TO THE FINANCIAL STATEMENTS (continued)

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

	Bank								Total		
	Repayable on demand	One month or less	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity			
		on demand									
of which:											
Certificates of deposit included in:											
- trading assets	-	-	-	-	-	-	-	-	-		
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-		
- available-for-sale investments	-	<u>692</u>	<u>848</u>	<u>2,716</u>	<u>209</u>	-	-	<u>18</u>	<u>4,483</u>		
	<u>692</u>	<u>848</u>	<u>2,716</u>	<u>209</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>18</u>	<u>4,483</u>		
Debt securities included in:											
- trading assets	-	-	-	-	-	-	<u>22,288</u>	-	<u>22,288</u>		
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-		
- available-for-sale investments	-	<u>33,752</u>	<u>48,308</u>	<u>46,392</u>	<u>32,540</u>	<u>2,041</u>	<u>-</u>	<u>296</u>	<u>163,329</u>		
	<u>33,752</u>	<u>48,308</u>	<u>46,392</u>	<u>32,540</u>	<u>2,041</u>	<u>22,288</u>	<u>-</u>	<u>296</u>	<u>185,617</u>		
Certificates of deposit in issue included in:											
- trading liabilities	-	-	-	-	-	-	-	-	-		
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-		
- issue at amortised cost	-	-	-	<u>3,949</u>	<u>4,652</u>	-	-	-	<u>8,601</u>		
	<u>-</u>	<u>-</u>	<u>-</u>	<u>3,949</u>	<u>4,652</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>8,601</u>		

NOTES TO THE FINANCIAL STATEMENTS (continued)

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

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2012 (restated)									
Assets									
Cash and balances with banks	18,250	-	-	-	-	-	-	-	18,250
Placings with and advances to banks	-	37,961	35,901	984	-	-	-	-	74,846
Trading assets	-	-	-	-	-	-	31,635	-	31,635
Derivative financial instruments	-	2	12	102	184	-	4,334	-	4,634
Loans and advances to customers	10,171	35,059	32,959	90,266	161,518	146,761	-	-	476,734
Amounts due from subsidiaries	885	61,814	6,796	4,214	7,112	322	-	-	81,143
Financial investments:									
- available-for-sale investments	-	19,981	63,601	35,066	24,467	1,656	-	643	145,414
Investments in subsidiaries	-	-	-	-	-	-	-	14,778	14,778
Interest in associates	-	-	-	-	-	-	-	5,172	5,172
Investment properties	-	-	-	-	-	-	-	2,988	2,988
Premises, plant and equipment	-	-	-	-	-	-	-	14,135	14,135
Intangible assets	-	-	-	-	-	-	-	406	406
Other assets	12,119	2,628	1,638	283	11	103	-	31	16,813
	41,425	157,445	140,907	130,915	193,292	148,842	35,969	38,153	886,948
Liabilities									
Current, savings and other deposit accounts	553,445	100,059	56,950	19,912	167	-	-	-	730,533
Deposits from banks	3,289	8,169	2,491	3	-	-	-	-	13,952
Trading liabilities	-	-	-	-	-	-	27,776	-	27,776
Derivative financial instruments	-	-	3	25	430	252	2,807	-	3,517
Certificates of deposit and other debt securities in issue:									
- certificates of deposit in issue	-	-	-	7,353	3,938	-	-	-	11,291
Amounts due to subsidiaries	5,441	9,330	510	-	-	-	-	1	15,282
Other liabilities	7,433	3,914	1,771	848	40	19	-	3,464	17,489
Current tax liabilities	-	-	-	509	-	-	-	-	509
Deferred tax liabilities	-	-	-	-	-	-	-	1,687	1,687
Subordinated liabilities	-	-	-	-	-	11,821	-	-	11,821
	569,608	121,472	61,725	28,650	4,575	12,092	30,583	5,152	833,857

NOTES TO THE FINANCIAL STATEMENTS (continued)

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

	Repayable on demand	One month or less but not on demand	Bank					No contractual maturity	Total				
			Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading						
of which:													
Certificates of deposit included in:													
- trading assets	-	-	-	-	-	-	400	-	400				
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-				
- available-for-sale investments	-	380	2,758	2,836	668	-	-	36	6,678				
- held-to-maturity debt securities	-	-	-	-	-	-	400	-	-				
	380	2,758	2,836	668	-	-	400	36	7,078				
Debt securities included in:													
- trading assets	-	-	-	-	-	-	30,150	-	30,150				
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-				
- available-for-sale investments	-	19,601	60,843	32,230	23,799	1,656	-	501	138,630				
- held-to-maturity debt securities	-	-	-	-	-	-	30,150	-	-				
	19,601	60,843	32,230	23,799	1,656	-	30,150	501	168,780				
Certificates of deposit in issue included in:													
- trading liabilities	-	-	-	-	-	-	-	-	-				
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-				
- issue at amortised cost	-	-	-	7,353	3,938	-	-	-	11,291				
	-	-	-	7,353	3,938	-	-	-	11,291				

NOTES TO THE FINANCIAL STATEMENTS (continued)

25 Accounting classifications

The tables below set out the Group's classification of financial assets and liabilities:

	Group						
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	Total
2013							
Cash and balances with banks	-	-	-	-	-	33,294	33,294
Placings with and advances to banks	-	-	-	-	131,363	-	131,363
Derivative financial instruments	5,870	-	776	-	-	-	6,646
Loans and advances to customers	-	-	-	-	586,240	-	586,240
Investment securities	23,835	6,987	211,340	71,505	-	-	313,667
Acceptances and endorsements	-	-	-	-	-	6,351	6,351
Other financial assets	8,161	-	-	-	-	10,131	18,292
Total financial assets	<u>37,866</u>	<u>6,987</u>	<u>212,116</u>	<u>71,505</u>	<u>717,603</u>	<u>49,776</u>	<u>1,095,853</u>
Non-financial assets							47,877
Total assets							<u><u>1,143,730</u></u>
Current, savings and other deposit accounts	34,489	-	-	-	-	824,996	859,485
Deposits from banks	-	-	-	-	-	11,826	11,826
Derivative financial instruments	4,525	-	721	-	-	-	5,246
Certificates of deposit and other debt securities in issue	1,615	-	-	-	-	8,601	10,216
Other financial liabilities	26,013	-	-	-	-	11,320	37,333
Subordinated liabilities	-	-	-	-	-	11,824	11,824
Liabilities to customers under investment contracts	-	489	-	-	-	-	489
Acceptances and endorsements	-	-	-	-	-	6,351	6,351
Total financial liabilities	<u>66,642</u>	<u>489</u>	<u>721</u>	<u>-</u>	<u>-</u>	<u>874,918</u>	<u>942,770</u>
Non-financial liabilities							93,182
Total liabilities							<u><u>1,035,952</u></u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

25 Accounting classifications (continued)

	Group						
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	Total
2012 (restated)							
Cash and balances with banks	-	-	-	-	-	20,506	20,506
Placings with and advances to banks	-	-	-	-	140,382	-	140,382
Derivative financial instruments	4,840	-	339	-	-	-	5,179
Loans and advances to customers	-	-	-	-	536,162	-	536,162
Investment securities	33,344	8,343	185,777	67,631	-	-	295,095
Acceptances and endorsements	-	-	-	-	-	5,264	5,264
Other financial assets	1,055	-	-	-	-	10,165	11,220
Total financial assets	39,239	8,343	186,116	67,631	676,544	35,935	1,013,808
Non-financial assets							63,288
Total assets							1,077,096
Current, savings and other deposit accounts	38,113	-	-	-	-	769,147	807,260
Deposits from banks	-	-	-	-	-	19,845	19,845
Derivative financial instruments	2,763	-	1,355	-	-	-	4,118
Certificates of deposit and other debt securities in issue	248	-	-	-	-	11,291	11,539
Other financial liabilities	21,492	-	-	-	-	12,705	34,197
Subordinated liabilities	-	-	-	-	-	11,821	11,821
Liabilities to customers under investment contracts	-	464	-	-	-	-	464
Acceptances and endorsements	-	-	-	-	-	5,264	5,264
Total financial liabilities	62,616	464	1,355	-	-	830,073	894,508
Non-financial liabilities							90,265
Total liabilities							984,773

NOTES TO THE FINANCIAL STATEMENTS (continued)

25 Accounting classifications (continued)

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2013							
Cash and balances with banks	-	-	-	-	-	30,009	30,009
Placings with and advances to banks	-	-	-	-	96,788	-	96,788
Derivative financial instruments	5,061	-	776	-	-	-	5,837
Loans and advances to customers	-	-	-	-	519,135	-	519,135
Investment securities	22,316	-	195,524	-	-	-	217,840
Amounts due from subsidiaries	-	-	-	-	-	23,553	23,553
Acceptances and endorsements	-	-	-	-	-	3,254	3,254
Other financial assets	8,161	-	-	-	-	7,226	15,387
Total financial assets	<u>35,538</u>	<u>-</u>	<u>196,300</u>	<u>-</u>	<u>615,923</u>	<u>64,042</u>	<u>911,803</u>
Non-financial assets							44,918
Total assets							<u>956,721</u>
Current, savings and other deposit accounts	2,286	-	-	-	-	774,462	776,748
Deposits from banks	-	-	-	-	-	10,012	10,012
Derivative financial instruments	3,765	-	721	-	-	-	4,486
Certificates of deposit and other debt securities in issue	1,615	-	-	-	-	8,601	10,216
Amounts due to subsidiaries	-	-	-	-	-	14,326	14,326
Other financial liabilities	26,013	-	-	-	-	9,930	35,943
Subordinated liabilities	-	-	-	-	-	11,824	11,824
Acceptances and endorsements	-	-	-	-	-	3,254	3,254
Total financial liabilities	<u>33,679</u>	<u>-</u>	<u>721</u>	<u>-</u>	<u>-</u>	<u>832,409</u>	<u>866,809</u>
Non-financial liabilities							5,265
Total liabilities							<u>872,074</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

25 Accounting classifications (continued)

	Bank						
	Trading	Designated at fair value	Available- for-sale/ hedging	Held-to- maturity	Loans and receivables	Other amortised cost	Total
2012 (restated)							
Cash and balances with banks	-	-	-	-	-	18,250	18,250
Placings with and advances to banks	-	-	-	-	74,846	-	74,846
Derivative financial instruments	4,334	-	300	-	-	-	4,634
Loans and advances to customers	-	-	-	-	476,734	-	476,734
Investment securities	30,580	-	145,414	-	-	-	175,994
Amounts due from subsidiaries	-	-	-	-	-	81,143	81,143
Acceptances and endorsements	-	-	-	-	-	2,548	2,548
Other financial assets	1,055	-	-	-	-	7,205	8,260
Total financial assets	<u>35,969</u>	<u>-</u>	<u>145,714</u>	<u>-</u>	<u>551,580</u>	<u>109,146</u>	<u>842,409</u>
Non-financial assets							44,539
Total assets							<u>886,948</u>
Current, savings and other deposit accounts	6,036	-	-	-	-	730,533	736,569
Deposits from banks	-	-	-	-	-	13,952	13,952
Derivative financial instruments	2,807	-	710	-	-	-	3,517
Certificates of deposit and other debt securities in issue	248	-	-	-	-	11,291	11,539
Amounts due to subsidiaries	-	-	-	-	-	15,282	15,282
Other financial liabilities	21,492	-	-	-	-	11,448	32,940
Subordinated liabilities	-	-	-	-	-	11,821	11,821
Acceptances and endorsements	-	-	-	-	-	2,548	2,548
Total financial liabilities	<u>30,583</u>	<u>-</u>	<u>710</u>	<u>-</u>	<u>-</u>	<u>796,875</u>	<u>828,168</u>
Non-financial liabilities							5,689
Total liabilities							<u>833,857</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

26 Cash and balances with banks

	Group	Bank		
	2013	2012 (restated)	2013	2012 (restated)
Cash in hand	6,005	4,465	5,742	4,207
Balances with central banks	16,712	8,973	14,663	7,486
Balances with banks	<u>10,577</u>	<u>7,068</u>	<u>9,604</u>	<u>6,557</u>
	<u><u>33,294</u></u>	<u><u>20,506</u></u>	<u><u>30,009</u></u>	<u><u>18,250</u></u>

27 Placings with and advances to banks

	Group	Bank	
	2013	2012	2013
Placings with and advances to banks maturing within one month	64,749	77,367	38,286
Placings with and advances to banks maturing after one month but less than one year	64,586	61,316	58,502
Placings with and advances to banks maturing after one year	<u>2,028</u>	<u>1,699</u>	<u>-</u>
	<u><u>131,363</u></u>	<u><u>140,382</u></u>	<u><u>96,788</u></u>
			74,846

There were no overdue advances, impaired advances and rescheduled advances to banks at 31 December 2013 by the Group and the Bank (2012: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

28 Trading assets

	Group	Bank		
	2013	2012	2013	2012
Treasury bills	18,336	26,808	18,336	26,808
Certificates of deposit	-	400	-	400
Other debt securities	5,471	6,106	3,952	3,342
Debt securities	23,807	33,314	22,288	30,550
Investment funds	28	30	28	30
Total trading securities	23,835	33,344	22,316	30,580
Other*	8,161	1,055	8,161	1,055
Total trading assets	31,996	34,399	30,477	31,635
Debt securities:				
- listed in Hong Kong	3,783	3,046	3,783	3,046
- listed outside Hong Kong	169	238	169	238
	3,952	3,284	3,952	3,284
- unlisted	19,855	30,030	18,336	27,266
	23,807	33,314	22,288	30,550
Investment funds:				
- listed in Hong Kong	28	30	28	30
Total trading securities	23,835	33,344	22,316	30,580
Debt securities:				
Issued by public bodies:				
- central governments and central banks	22,650	31,105	22,119	29,846
- other public sector entities	-	80	-	80
	22,650	31,185	22,119	29,926
Issued by other bodies:				
- banks	853	934	169	573
- corporate entities	304	1,195	-	51
	1,157	2,129	169	624
	23,807	33,314	22,288	30,550
Investment funds:				
Issued by corporate entities	28	30	28	30
Total trading securities	23,835	33,344	22,316	30,580

* This represents amount receivable from counterparties on trading transactions not yet settled.

NOTES TO THE FINANCIAL STATEMENTS (continued)

29 Financial assets designated at fair value

	Group	Bank	
	2013	2012	2013
	2012		2012
Certificates of deposit	-	-	-
Other debt securities	812	4,047	-
Debt securities	812	4,047	-
Equity shares	3,639	1,632	-
Investment funds	2,536	2,664	-
	6,987	8,343	-
Debt securities:			
- listed in Hong Kong	103	38	-
- listed outside Hong Kong	541	336	-
	644	374	-
- unlisted	168	3,673	-
	812	4,047	-
Equity shares:			
- listed in Hong Kong	2,072	1,632	-
- listed outside Hong Kong	1,546	-	-
	3,618	1,632	-
- unlisted	21	-	-
	3,639	1,632	-
Investment funds:			
- listed in Hong Kong	32	30	-
- listed outside Hong Kong	314	599	-
	346	629	-
- unlisted	2,190	2,035	-
	2,536	2,664	-
	6,987	8,343	-
Debt securities:			
Issued by public bodies:			
- central governments and central banks	358	181	-
- other public sector entities	44	1	-
	402	182	-
Issued by other bodies:			
- banks	208	3,687	-
- corporate entities	202	178	-
	410	3,865	-
	812	4,047	-
Equity shares:			
Issued by banks	634	370	-
Issued by public sector entities	12	13	-
Issued by corporate entities	2,993	1,249	-
	3,639	1,632	-
Investment funds:			
Issued by banks	-	400	-
Issued by corporate entities	2,536	2,264	-
	2,536	2,664	-
	6,987	8,343	-

NOTES TO THE FINANCIAL STATEMENTS (continued)

30 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 standards used to control credit risk for other 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 Management Discussion and Analysis.

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative financial instruments are held for trading, or financial instruments designated at fair value, or designated as either fair value hedge or cash flow hedge. The Group primarily traded over-the-counter derivatives and also participated in exchange traded derivatives.

Trading derivatives

Most of the Group's trading derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters.

Derivatives classified as held for trading include non-qualifying hedging derivatives and ineffective hedging derivatives. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

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 managing the balance sheet, 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)

30 Derivative financial instruments (continued)

(b) Cash flow hedge

The Group is exposed to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio for financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedge of forecast transactions.

Gains and losses are initially recognised in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year ended 31 December 2013, the amount of cash flow hedging reserve transferred to the income statement consist of HK\$46 million (2012: HK\$68 million) in net interest income and HK\$399 million (2012: HK\$260 million) in net trading income.

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2013 and 2012. During the years of 2013 and 2012, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur. A gain of HK\$3 million for 2013 (2012: Nil) was recognised due to termination of such forecast transactions.

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

	Group		
	Three months or less	Over three months but within one year	Over one year but within five years
At 31 December 2013			
Cash inflows from assets	4,633	5,759	4,816
Cash outflows from liabilities	-	-	-
Net cash inflows	<u>4,633</u>	<u>5,759</u>	<u>4,816</u>
At 31 December 2012			
Cash inflows from assets	10,994	10,567	2,734
Cash outflows from liabilities	-	-	-
Net cash inflows	<u>10,994</u>	<u>10,567</u>	<u>2,734</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

30 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			2012		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Exchange rate contracts:						
- spot and forward foreign exchange	590,846	4,066	2,849	607,543	2,865	1,238
- currency swaps	1,742	4	10	3,819	21	22
- currency options purchased	104,145	183	-	104,562	138	-
- currency options written	105,366	-	160	110,249	-	158
- other exchange rate contracts	-	-	-	37	-	1
	802,099	4,253	3,019	826,210	3,024	1,419
Interest rate contracts:						
- interest rate swaps	193,275	1,553	1,348	192,293	1,438	1,292
- other interest rate contracts	78	-	-	128	-	-
	193,353	1,553	1,348	192,421	1,438	1,292
Equity and other contracts:						
- equity swaps	2,883	16	109	2,841	125	16
- equity options purchased	3,161	44	-	11,732	199	-
- equity options written	2,979	-	42	2,018	-	30
- other equity contracts	-	-	-	-	-	-
- spot and forward contracts and others	965	4	7	1,023	54	6
	9,988	64	158	17,614	378	52
Total derivatives held for trading	1,005,440	5,870	4,525	1,036,245	4,840	2,763
Derivatives managed in conjunction with financial assets designated at fair value						
Interest rate contracts:						
- interest rate swaps	-	-	-	-	-	-
Cash flow hedge derivatives						
Exchange rate contracts:						
- currency swaps	3,463	667	6	4,263	280	3
Interest rate contracts:						
- interest rate swaps	3,100	5	2	10,313	20	2
	6,563	672	8	14,576	300	5
Fair value hedge derivatives						
Interest rate contracts:						
- interest rate swaps	29,149	104	713	27,426	39	1,350
Total derivatives	1,041,152	6,646	5,246	1,078,247	5,179	4,118

NOTES TO THE FINANCIAL STATEMENTS (continued)

30 Derivative financial instruments (continued)

	Bank					
	2013			2012		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Exchange rate contracts:						
- spot and forward foreign exchange	526,467	3,725	2,411	576,318	2,737	1,155
- currency swaps	505	3	-	3,068	21	20
- currency options purchased	104,223	183	-	104,762	139	-
- currency options written	105,515	-	305	110,394	-	316
- other exchange rate contracts	-	-	-	37	-	1
	736,710	3,911	2,716	794,579	2,897	1,492
Interest rate contracts:						
- interest rate swaps	153,489	998	874	142,922	1,209	1,141
- other interest rate contracts	78	-	-	128	-	-
	153,567	998	874	143,050	1,209	1,141
Equity and other contracts:						
- equity swaps	4,638	98	124	5,432	140	137
- equity options purchased	3,161	44	-	2,015	28	-
- equity options written	3,162	-	44	2,018	-	31
- other equity contracts	-	-	-	-	-	-
- spot and forward contracts and others	1,300	10	7	1,358	60	6
	12,261	152	175	10,823	228	174
Total derivatives held for trading	902,538	5,061	3,765	948,452	4,334	2,807
Derivatives managed in conjunction with financial assets designated at fair value						
Interest rate contracts:						
- interest rate swaps	-	-	-	-	-	-
Cash flow hedge derivatives						
Exchange rate contracts:						
- currency swaps	3,463	667	6	4,263	280	3
Interest rate contracts:						
- interest rate swaps	3,100	5	2	10,190	20	2
	6,563	672	8	14,453	300	5
Fair value hedge derivatives						
Interest rate contracts:						
- interest rate swaps	29,149	104	713	10,059	-	705
Total derivatives						
	938,250	5,837	4,486	972,964	4,634	3,517

The above derivative assets and liabilities, being the positive or negative marked-to-market value of the respective derivative contracts, represent gross replacement costs.

NOTES TO THE FINANCIAL STATEMENTS (continued)

30 Derivative financial instruments (continued)

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

The table below gives the contract amounts, credit equivalent amounts and risk-weighted amounts of derivatives. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

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

The credit equivalent amounts after taking into account of recognised netting are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Banking (Capital) Rules ("the Capital Rules") and depend on the status of the counterparty and maturity characteristics of the instrument.

Where a legally enforceable bilateral netting is arranged with counterparty, the Group has the right to offset the gross amount of positive marked-to-market assets with any negative marked-to-market liabilities with the same customer. These offsets are recognised by the Hong Kong Monetary Authority in the calculation of risk assets for the capital adequacy ratio.

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 2013 and 2012 were calculated based on the advanced internal ratings-based approach.

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2013						
Exchange rate contracts:						
- spot and forward foreign exchange	537,659	4,414	1,133	480,068	3,397	731
- currency swaps	3,991	742	86	3,968	741	86
- currency options purchased	104,218	2,909	2,484	104,293	2,911	2,484
- other exchange rate contracts	14	-	-	14	-	-
	<u>645,882</u>	<u>8,065</u>	<u>3,703</u>	<u>588,343</u>	<u>7,049</u>	<u>3,301</u>
Interest rate contracts:						
- interest rate swaps	225,524	2,021	626	185,738	1,373	278
- interest rate options purchased	-	-	-	-	-	-
- other interest rate contracts	78	-	-	78	-	-
	<u>225,602</u>	<u>2,021</u>	<u>626</u>	<u>185,816</u>	<u>1,373</u>	<u>278</u>
Equity and other contracts:						
- equity swaps	2,883	190	24	4,639	380	46
- equity options purchased	3,161	233	164	3,161	233	164
- others	-	-	-	-	-	-
	<u>6,044</u>	<u>423</u>	<u>188</u>	<u>7,800</u>	<u>613</u>	<u>210</u>

The total fair value of the derivatives at 31 December 2013 was HK\$3,093 million (31 December 2012: HK\$2,965 million) after taking into account the effect of valid bilateral netting agreement amounting to HK\$3,103 million (31 December 2012: HK\$1,641 million).

NOTES TO THE FINANCIAL STATEMENTS (continued)

30 Derivative financial instruments (continued)

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

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2012						
Exchange rate contracts:						
- spot and forward foreign exchange	544,790	4,197	728	517,479	3,759	596
- currency swaps	7,330	481	58	7,330	481	58
- currency options purchased	104,578	1,874	1,487	104,724	1,877	1,488
- other exchange rate contracts	37	-	-	37	-	-
	656,735	6,552	2,273	629,570	6,117	2,142
Interest rate contracts:						
- interest rate swaps	230,032	2,121	472	163,171	1,666	278
- interest rate options purchased	-	-	-	-	-	-
	230,032	2,121	472	163,171	1,666	278
Equity and other contracts:						
- equity swaps	2,841	300	42	5,432	478	58
- equity options purchased	2,015	152	101	2,015	152	101
- others	-	-	-	-	-	-
	4,856	452	143	7,447	630	159

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers

(a) Loans and advances to customers

	Group	Bank	
	2013	2012	2013
	2012	2013	2012
Gross loans and advances to customers	587,688	537,571	520,279
Less:			
Loan impairment allowances			
- individually assessed	(709)	(681)	(534)
- collectively assessed	(739)	(728)	(610)
	586,240	536,162	519,135
			476,734

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

	Group	Bank	
	2013 %	2012 %	2013 %
	2012 %	2013	2012
Loan impairment allowances:			
- individually assessed	0.12	0.13	0.10
- collectively assessed	0.13	0.13	0.12
Total loan impairment allowances	0.25	0.26	0.22
			0.23

(b) Loan impairment allowances against loans and advances to customers

2013	Group		
	Individually assessed	Collectively assessed	Total
At 1 January	681	728	1,409
Amounts written off	(69)	(494)	(563)
Recoveries of advances written off in previous years	16	52	68
New impairment allowances charged			
to income statement (note 12)	191	562	753
Impairment allowances released to income statement (note 12)	(107)	(110)	(217)
Unwinding of discount of loan impairment allowances			
recognised as "interest income"	(5)	(4)	(9)
Exchange	2	5	7
At 31 December	709	739	1,448
2012			
At 1 January	896	771	1,667
Amounts written off	(277)	(416)	(693)
Recoveries of advances written off in previous years	13	47	60
New impairment allowances charged			
to income statement (note 12)	294	376	670
Impairment allowances released to income statement (note 12)	(237)	(47)	(284)
Unwinding of discount of loan impairment allowances			
recognised as "interest income"	(7)	(3)	(10)
Exchange	(1)	-	(1)
At 31 December	681	728	1,409

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers (continued)

(b) Loan impairment allowances against loans and advances to customers (continued)

	Bank		
	Individually assessed	Collectively assessed	Total
2013			
At 1 January	503	580	1,083
Amounts written off	(40)	(494)	(534)
Recoveries of advances written off in previous years	9	52	61
New impairment allowances charged			
to income statement (note 12)	122	562	684
Impairment allowances released to income statement (note 12)	(56)	(86)	(142)
Unwinding of discount of loan impairment allowances			
recognised as "interest income"	(4)	(4)	(8)
At 31 December	534	610	1,144
2012			
At 1 January	789	620	1,409
Amounts written off	(276)	(416)	(692)
Recoveries of advances written off in previous years	4	47	51
New impairment allowances charged			
to income statement (note 12)	131	379	510
Impairment allowances released to income statement (note 12)	(139)	(47)	(186)
Unwinding of discount of loan impairment allowances			
recognised as "interest income"	(6)	(3)	(9)
At 31 December	503	580	1,083

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers (continued)

(c) Impaired loans and advances to customers and allowances

	Group	Bank	
	2013	2012	2013
Gross impaired loans and advances	1,311	1,340	1,097
Individually assessed allowances	<u>(709)</u>	<u>(681)</u>	<u>(534)</u>
Net impaired loans and advances	<u><u>602</u></u>	<u><u>659</u></u>	<u><u>563</u></u>
Individually assessed allowances as a percentage of gross impaired loans and advances	<u><u>54.1%</u></u>	<u><u>50.8%</u></u>	<u><u>48.7%</u></u>
Gross impaired loans and advances as a percentage of gross loans and advances to customers	<u><u>0.22%</u></u>	<u><u>0.25%</u></u>	<u><u>0.21%</u></u>

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

	Group	Bank	
	2013	2012	2013
Gross individually assessed impaired loans and advances	1,157	1,190	943
Individually assessed allowances	<u>(709)</u>	<u>(681)</u>	<u>(534)</u>
	<u><u>448</u></u>	<u><u>509</u></u>	<u><u>409</u></u>
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	<u><u>0.20%</u></u>	<u><u>0.22%</u></u>	<u><u>0.18%</u></u>
Amount of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	<u><u>516</u></u>	<u><u>498</u></u>	<u><u>365</u></u>
	<u><u>320</u></u>		

Collateral includes any tangible security 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 loans and advances to customers, only the amount of collateral up to the gross loans and advances is included.

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers (continued)

(d) Overdue loans and advances to customers

Loans and advances to customers that are more than three months overdue and their expression as a percentage of gross loans and advances to customers are as follows:

	Group	%	Bank	%
2013				
Gross loans and advances				
which have been overdue with respect to either principal or interest for periods of:				
- more than three months				
but not more than six months	121	-	101	-
- more than six months				
but not more than one year	73	-	47	-
- more than one year	<u>637</u>	<u>0.1</u>	<u>516</u>	<u>0.1</u>
	<u><u>831</u></u>	<u><u>0.1</u></u>	<u><u>664</u></u>	<u><u>0.1</u></u>

of which:

- individually impaired allowances	(583)	(454)
- covered portion of overdue loans and advances	298	168
- uncovered portion of overdue loans and advances	533	496
- current market value of collateral held against the covered portion of overdue loans and advances	599	421

2012

Gross loans and advances
which have been overdue with respect to either principal or interest for periods of:

- more than three months				
but not more than six months	114	-	98	-
- more than six months				
but not more than one year	143	-	56	-
- more than one year	<u>662</u>	<u>0.2</u>	<u>583</u>	<u>0.2</u>
	<u><u>919</u></u>	<u><u>0.2</u></u>	<u><u>737</u></u>	<u><u>0.2</u></u>

of which:

- individually impaired allowances	(515)	(345)
- covered portion of overdue loans and advances	241	84
- uncovered portion of overdue loans and advances	678	653
- current market value of collateral held against the covered portion of overdue loans and advances	373	157

Collateral held with respect to overdue loans and advances is mainly residential properties and commercial properties. The current market value of residential properties and commercial properties were HK\$384 million and HK\$164 million respectively.

Loans and advances with a specific repayment date are classified as overdue when the principal or interest is overdue and remains unpaid at year-end. Loans and advances repayable by regular instalments are treated as overdue when an instalment payment is overdue and remains unpaid at year-end. Loans and 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 loans and 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)

31 Loans and advances to customers (continued)

(e) Rescheduled loans and advances to customers

Rescheduled loans and advances to customers and their expression as a percentage of gross loans and advances to customers are as follows:

	Group	%	Bank	%
2013	<u>123</u>	-	<u>121</u>	-
2012	<u>196</u>	-	<u>133</u>	-

Rescheduled loans and advances to customers are those loans and advances 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 loans and 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 loans and advances to customers" (note 31(d)).

(f) Segmental analysis of loans and advances to customers by geographical area

Loans and 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 a loan is guaranteed by a party located in an area that is different from that of the counterparty.

	Group				
	Gross loans and advances	Individually impaired loans and advances	Overdue loans and advances	Individually assessed allowances	Collectively assessed allowances
At 31 December 2013					
Hong Kong	480,545	924	642	527	589
Rest of Asia-Pacific	99,987	233	189	182	140
Others	7,156	-	-	-	10
	<u>587,688</u>	<u>1,157</u>	<u>831</u>	<u>709</u>	<u>739</u>
At 31 December 2012					
Hong Kong	447,310	948	718	503	561
Rest of Asia-Pacific	84,428	218	201	177	156
Others	5,833	24	-	1	11
	<u>537,571</u>	<u>1,190</u>	<u>919</u>	<u>681</u>	<u>728</u>
Bank					
	Gross loans and advances	Individually impaired loans and advances	Overdue loans and advances	Individually assessed allowances	Collectively assessed allowances
At 31 December 2013					
Hong Kong	464,740	911	639	527	569
Rest of Asia-Pacific	52,021	32	25	7	38
Others	3,518	-	-	-	3
	<u>520,279</u>	<u>943</u>	<u>664</u>	<u>534</u>	<u>610</u>
At 31 December 2012					
Hong Kong	431,548	925	715	502	539
Rest of Asia-Pacific	43,490	21	22	-	38
Others	2,779	24	-	1	3
	<u>477,817</u>	<u>970</u>	<u>737</u>	<u>503</u>	<u>580</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers (continued)

(g) Gross loans and advances to customers by industry sector

The analysis of gross loans and advances to customers by industry sector based on categories and definitions used by the Hong Kong Monetary Authority is as follows:

	Group	
	2013	2012
	% of gross advances covered by collateral	% of gross advances covered by collateral
Gross loans and advances to customers for use in Hong Kong		
Industrial, commercial and financial sectors		
- property development	30,529	47.2
- property investment	100,912	90.6
- financial concerns	2,773	46.4
- stockbrokers	304	46.2
- wholesale and retail trade	21,912	46.5
- manufacturing	17,372	37.6
- transport and transport equipment	6,289	67.8
- recreational activities	160	15.5
- information technology	1,870	43.4
- other	35,664	53.4
	<u>217,785</u>	<u>68.0</u>
		<u>203,237</u>
Individuals		
- loans and advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	14,452	100.0
- loans and advances for the purchase of other residential properties	131,305	100.0
- credit card loans and advances	21,419	-
- other	14,431	41.6
	<u>181,607</u>	<u>83.6</u>
		<u>172,965</u>
Total gross loans and advances for use in Hong Kong		
	399,392	75.1
Trade finance	52,117	19.6
Gross loans and advances for use outside Hong Kong		
	136,179	29.4
Gross loans and advances to customers		
	<u>587,688</u>	<u>59.6</u>
		<u>537,571</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers (continued)

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

	Bank		
	2013	% of gross advances covered by collateral	2012
Gross loans and advances to customers for use in Hong Kong			
Industrial, commercial and financial sectors			
- property development	30,529	47.2	29,771
- property investment	100,507	90.8	103,243
- financial concerns	2,773	46.4	3,595
- stockbrokers	304	46.2	325
- wholesale and retail trade	21,912	46.5	16,445
- manufacturing	17,372	37.6	15,212
- transport and transport equipment	5,968	66.3	5,398
- recreational activities	160	15.5	244
- information technology	1,870	43.4	1,430
- other	35,544	53.6	26,290
	<u>216,939</u>	<u>68.1</u>	<u>201,953</u>
Individuals			
- loans and advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	9,737	100.0	7,904
- loans and advances for the purchase of other residential properties	130,615	100.0	124,277
- credit card loans and advances	21,419	-	20,389
- other	14,429	41.6	13,510
	<u>176,200</u>	<u>83.1</u>	<u>166,080</u>
Total gross loans and advances for use in Hong Kong			
	393,139	74.8	368,033
Trade finance			
	52,117	19.6	47,555
Gross loans and advances for use outside Hong Kong			
	75,023	13.9	62,229
Gross loans and advances to customers			
	<u>520,279</u>	<u>60.5</u>	<u>477,817</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers (continued)

(h) Net investments in finance leases

Loans and advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring by the lessee the leased asset at nominal value at the end of the lease period. The total minimum lease payments receivable and their present value at the year-end are as follows:

	Group		Bank	
	2013	2012	2013	2012
Finance leases	-	-	-	-
Hire purchase contracts	4,194	3,824	3,872	3,447
	<u>4,194</u>	<u>3,824</u>	<u>3,872</u>	<u>3,447</u>

	Group		
	Present value of minimum lease payments receivable	Interest income relating to future periods	Total minimum lease payments receivable
2013			
Amounts receivable:			
- within one year	303	57	360
- after one year but within five years	988	187	1,175
- after five years	<u>2,903</u>	<u>288</u>	<u>3,191</u>
	<u>4,194</u>	<u>532</u>	<u>4,726</u>
Loans impairment allowances	-		
Net investments in finance leases and hire purchase contracts	<u>4,194</u>		
2012			
Amounts receivable:			
- within one year	360	60	420
- after one year but within five years	937	194	1,131
- after five years	<u>2,528</u>	<u>302</u>	<u>2,830</u>
	<u>3,825</u>	<u>556</u>	<u>4,381</u>
Loans impairment allowances	(1)		
Net investments in finance leases and hire purchase contracts	<u>3,824</u>		

NOTES TO THE FINANCIAL STATEMENTS (continued)

31 Loans and advances to customers (continued)

(h) Net investments in finance leases (continued)

	Bank		
	Present value of minimum lease payments receivable	Interest income relating to future periods	Total minimum lease payments receivable
2013			
Amounts receivable:			
- within one year	273	51	324
- after one year but within five years	867	167	1,034
- after five years	<u>2,732</u>	<u>277</u>	<u>3,009</u>
	<u>3,872</u>	<u>495</u>	<u>4,367</u>
Loans impairment allowances	-		
Net investments in finance leases and hire purchase contracts	<u>3,872</u>		
2012			
Amounts receivable:			
- within one year	329	53	382
- after one year but within five years	806	170	976
- after five years	<u>2,313</u>	<u>286</u>	<u>2,599</u>
	<u>3,448</u>	<u>509</u>	<u>3,957</u>
Loans impairment allowances	(1)		
Net investments in finance leases and hire purchase contracts	<u>3,447</u>		

NOTES TO THE FINANCIAL STATEMENTS (continued)

32 Financial investments

	Group	Bank	
	2013	2012	2013
Financial investments:			
- which may be repledged or resold by counterparties	96	88	96
- which may not be repledged or resold or are not subject to repledge or resale by counterparties	282,749	253,320	195,428
	282,845	253,408	145,326
	282,845	253,408	145,414
Held-to-maturity debt securities at amortised cost	71,505	67,631	-
Available-for-sale at fair value:			
- debt securities	183,344	185,443	167,812
- equity shares	27,948	295	27,712
- investment funds	48	39	-
	282,845	253,408	145,414
Treasury bills	91,811	98,262	91,811
Certificates of deposit	9,729	11,228	4,483
Other debt securities	153,309	143,584	71,518
Debt securities	254,849	253,074	167,812
Equity shares	27,948	295	27,712
Investment funds	48	39	-
	282,845	253,408	145,414

There were no overdue debt securities at 31 December 2013 (31 December 2012: Nil) for the Group and the Bank. The Group did not hold any asset-backed securities, mortgage-backed securities and collateralised debt obligations.

(a) Held-to-maturity debt securities

	Group	Bank	
	2013	2012	2013
Listed in Hong Kong			
Listed in Hong Kong	1,447	1,616	-
Listed outside Hong Kong	14,749	13,578	-
	16,196	15,194	-
Unlisted			
Unlisted	55,309	52,437	-
	71,505	67,631	-
Issued by public bodies:			
- central governments and central banks	1,168	808	-
- other public sector entities	11,129	8,345	-
	12,297	9,153	-
Issued by other bodies:			
- banks	32,252	38,225	-
- corporate entities	26,956	20,253	-
	59,208	58,478	-
	71,505	67,631	-
Fair value of held-to-maturity debt securities:			
- listed	16,419	16,602	-
- unlisted	55,595	56,114	-
	72,014	72,716	-

There were no held-to-maturity debt securities determined to be impaired at 31 December 2013 for the Group and the Bank (31 December 2012: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

32 Financial investments (continued)

(b) Available-for-sale debt securities

	Group	Bank	
	2013	2012	2013
	2012		2012
Listed in Hong Kong	10,262	15,009	10,262
Listed outside Hong Kong	<u>33,675</u>	<u>34,588</u>	<u>33,675</u>
	<u>43,937</u>	<u>49,597</u>	<u>43,937</u>
Unlisted	<u>139,407</u>	<u>135,846</u>	<u>123,875</u>
	<u>183,344</u>	<u>185,443</u>	<u>167,812</u>
 Issued by public bodies:			
- central governments and central banks	126,431	127,779	112,587
- other public sector entities	16,551	15,293	16,551
	<u>142,982</u>	<u>143,072</u>	<u>129,138</u>
 Issued by other bodies:			
- banks	36,937	38,629	35,249
- corporate entities	3,425	3,742	3,425
	<u>40,362</u>	<u>42,371</u>	<u>38,674</u>
	<u>183,344</u>	<u>185,443</u>	<u>167,812</u>

At 31 December 2013 and 2012, there were no available-for-sale debt securities determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities for the Group and the Bank.

(c) Available-for-sale equity shares

	Group	Bank	
	2013	2012	2013
	2012		2012
Listed in Hong Kong	67	65	-
Listed outside Hong Kong	<u>26,897</u>	<u>6</u>	<u>26,897</u>
	<u>26,964</u>	<u>71</u>	<u>26,897</u>
Unlisted	<u>984</u>	<u>224</u>	<u>815</u>
	<u>27,948</u>	<u>295</u>	<u>27,712</u>
 Issued by banks	27,510	6	27,510
Issued by corporate entities	<u>438</u>	<u>289</u>	<u>202</u>
	<u>27,948</u>	<u>295</u>	<u>27,712</u>

There were no available-for-sale equity securities determined to be impaired during the year of 2013 and 2012 for the Group and the Bank.

(d) Available-for-sale investment funds

	Group	Bank	
	2013	2012	2013
	2012		2012
Unlisted	<u>48</u>	<u>39</u>	-
Issued by corporate entities	<u>48</u>	<u>39</u>	-

There were no available-for-sale investment funds determined to be impaired during the year of 2013 and 2012 for the Group and the Bank.

NOTES TO THE FINANCIAL STATEMENTS (continued)

33 Transfers of financial assets not qualifying for derecognition

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

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

The majority of transferred financial assets that do not qualify for derecognition are securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets transferred to third parties that did not qualify for derecognition during 2013 and 2012.

Financial assets and associated financial liabilities not qualifying for full derecognition

	Group and Bank			
	2013			
	Carrying amount of transferred assets	Carrying amount of associated liabilities	Fair value of associated liabilities	Net position
Transaction not qualifying for full derecognition:				
Securities lending agreements	<u>96</u>	<u>-</u>	<u>-</u>	<u>96</u>
	2012			
	Carrying amount of transferred assets	Carrying amount of associated liabilities	Fair value of associated liabilities	Net position
Transaction not qualifying for full derecognition:				
Securities lending agreements	<u>88</u>	<u>-</u>	<u>-</u>	<u>88</u>

There were no outstanding transferred financial assets in which the Group and the Bank has a continuing involvement, that were derecognised in their entirety at 31 December 2013 (31 December 2012: nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

34 Investments in subsidiaries

Unlisted shares, at cost

Bank	2013	2012
	<u>17,918</u>	<u>14,778</u>

The principal subsidiaries of the Bank are:

<u>Name of company</u>	<u>Place of incorporation</u>	<u>Principal activities</u>	<u>Issued equity capital</u>
Hang Seng Bank (China) Limited	People's Republic of China	Banking	RMB6,817,500,000
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 <i>(dissolved in 2013)</i>	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\$6,426,184,570
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
High Time Investments Limited	Hong Kong SAR	Investment holding	HK\$2,250,010,000

All the above companies are wholly-owned subsidiaries and unlisted. All subsidiaries are held directly by the Bank except for Hang Seng Life Limited and Hang Seng Indexes Company Limited. The principal places of operation are the same as the places of incorporation.

Some principal subsidiaries are regulated banking and insurance entities and as such, are required to maintain certain minimum levels of capital and liquid assets to support their operations. The effect of these regulatory requirements is to limit the extent to which the subsidiaries may transfer funds to the Bank in the form of repayment of certain shareholder loans or cash dividends.

NOTES TO THE FINANCIAL STATEMENTS (continued)

35 Interest in associates

	Group	Bank	
	2013	2012	2013
	2012	2012	2012
Unlisted investments, at cost	-	-	912
Listed investments, at cost	-	-	4,260
Share of net assets	2,062	24,151	-
Intangible asset	-	29	-
Goodwill	-	475	-
	2,062	24,655	5,172

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>
Unlisted				
Barrowgate Limited	Hong Kong SAR	Property investment	24.64%	HK\$10,000
GZHS Research Co., Ltd. (Formerly known as Guangzhou GuangZheng Hang Seng Securities Investment Advisory Co., Ltd.)	People's Republic of China	Conduct market/securities analysis and publish research reports	33.00%	RMB44,680,000
Yantai Bank Co., Ltd. ¹	People's Republic of China	Banking		
Listed				
Industrial Bank Co., Ltd. ²	People's Republic of China	Banking		

¹ The Group's investment in Yantai Bank Co., Ltd. ("Yantai Bank") was equity accounted with effect from January 2009, reflecting the Group's significant influence over this associate. On 13 December 2013, Yantai Bank approved an increase in its registered share capital to enable a private placement of additional share capital to a third party, leading to the Group's equity holding being diluted from 20% to 15.09%. As a result of this and other factors, the Group considers that it is no longer in a position to exercise significant influence over Yantai Bank and ceased to account for its investment as an associate from that date. Thereafter, the holding in Yantai Bank is classified as an available-for-sale financial investment.

² The Group's investment in Industrial Bank Co., Ltd. ("Industrial Bank") was equity accounted with effect from May 2004. The group's significant influence was established as a result of representation on the Board of Directors and the Bank's ability to participate in the decision making process. On 7 January 2013, Industrial Bank completed a private placement of additional share capital to a number of third parties, thereby diluting the Group's equity holding from 12.8% to 10.9%. As a result of this and other factors, the Group considers that it is no longer in a position to exercise significant influence over Industrial Bank and it therefore ceased to account for the investment as an associate from that date. The holding in Industrial Bank has since been recognised as an available-for-sale financial investment in the balance sheet of the Group, with any subsequent movement in its fair value reflected in accordance with current applicable Hong Kong Financial Reporting Standards. At 31 December 2013, there was a revaluation deficit on the investment in Industrial Bank recorded in the 'available-for-sale investment reserve', reflecting the decline in its fair value below the deemed cost upon reclassification based on the share price on 4 January 2013. The change in fair value of the Bank's investment in Industrial Bank is recognised in the available-for-sale investment reserve unless the investment becomes impaired. If the investment becomes impaired, the cumulative revaluation deficit would be reclassified from the available-for-sale investment reserve to the income statement.

The listed investment included in interest in associates as at 31 December 2012 amounted to HK\$22,099 million which represented the investment in Industrial Bank. The fair value of Industrial Bank based on quoted market price was HK\$28,409 million as at 31 December 2012. Following the reclassification of Industrial Bank to available-for-sale financial investment, there was no listed investment included in interest in associates as at 31 December 2013.

In accordance with HKAS 28 (2011) "Investments in Associates and Joint Ventures", 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 interests are recognised at cost and dividends accounted for as declared.

The interest in Barrowgate Limited and GZHS Research Co., Ltd. ("GZHS") are owned by the subsidiaries of the Bank.

All of the above associates are accounted for using the equity method in the consolidated financial statements as at 31 December 2013.

NOTES TO THE FINANCIAL STATEMENTS (*continued*)

35 Interest in associates (*continued*)

For the year ended 31 December 2013, the financial results of GZHS was included in the financial statements based on financial statements drawn up to 30 September 2013, but taking into account any changes in the subsequent period from 1 October 2013 to 31 December 2013 that would materially affect the results. The Group has taken advantage of the provision contained in HKAS 28 (2011) "Investments in Associates and Joint Ventures" 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.

	Assets	Liabilities	Equity	Revenue	Expenses	Revenue Less Expenses
2013						
100 per cent	9,562	1,223	8,339	3,618	1,228	2,390
The Group's effective interest	2,365	303	2,062	819	257	562
2012						
100 per cent	3,705,017	3,524,666	180,351	103,764	62,507	41,257
The Group's effective interest	478,174	454,023	24,151	13,536	8,155	5,381

There was no impairment loss on our interest in associates for the years ended 31 December 2013 and 2012.

NOTES TO THE FINANCIAL STATEMENTS (continued)

36 Investment properties

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2013, and were updated for any material changes in the valuation as at 31 December 2013. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of valuations of investment properties were market value which is consistent with the definition of fair value under HKFRS 13 "Fair Value Measurement" and take into account the highest and best use of the property from the perspective of market participants.

(a) Movement of investment properties

	Group	Bank		
	2013	2012	2013	2012
At 1 January	4,860	4,314	2,988	2,806
Additions	4,867	-	3,228	-
Surplus on revaluation credited to income statement	1,338	742	809	447
Transfer to assets held for sale	-	(228)	-	(228)
Transfer (to)/from premises (note 37(a))	(147)	32	(147)	(37)
At 31 December	10,918	4,860	6,878	2,988
Representing:				
- measure at valuation	10,918	4,860	6,878	2,988

(b) Terms of lease

	Group	Bank		
	2013	2012	2013	2012
Leaseholds				
Held in Hong Kong:				
- long leases (over 50 years unexpired)	1,593	1,510	653	668
- medium leases (10 to 50 years unexpired)	9,325	3,350	6,225	2,320
Held outside Hong Kong:				
- medium leases (10 to 50 years unexpired)	-	-	-	-
	10,918	4,860	6,878	2,988

- (c) The Group leases out investment properties under operating leases. The leases typically run for an initial period of 2 to 3 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.

	Group	Bank		
	2013	2012	2013	2012
Direct operating expenses arising from investment properties	26	23	18	15
Direct operating expenses from investment properties that generated rental income	25	22	17	14

The Group's total future minimum lease payments receivable under non-cancellable operating leases are as follows:

	Group	Bank		
	2013	2012	2013	2012
Less than one year	282	155	175	101
Over one year but within five years	183	86	110	55
Over five years	1	-	-	-
	466	241	285	156

NOTES TO THE FINANCIAL STATEMENTS (continued)

37 Premises, plant and equipment

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2013, and were updated for any material changes in the valuation as at 31 December 2013. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of valuations of premises were market value which is consistent with the definition of fair value under HKFRS 13 "Fair Value Measurement" and take into account the highest and best use of the property from the perspective of market participants.

(a) Movement of premises, plant and equipment

	Premises	Plant and equipment	Group Total
2013			
Cost or valuation:			
At 1 January	18,748	3,751	22,499
Additions	34	203	237
Disposals	-	(117)	(117)
Elimination of accumulated depreciation on revalued premises	(556)	-	(556)
Surplus on revaluation:			
- credited to premises revaluation reserve	2,103	-	2,103
- debited to income statement (note 18)	(3)	-	(3)
Transfer from investment properties (note 36(a))	147	-	147
Exchange adjustments and other	23	19	42
At 31 December	<u>20,496</u>	<u>3,856</u>	<u>24,352</u>
Accumulated depreciation:			
At 1 January	-	(3,237)	(3,237)
Exchange adjustments	-	(15)	(15)
Charge for the year (note 13)	(556)	(206)	(762)
Written off on disposal	-	106	106
Elimination of accumulated depreciation on revalued premises	556	-	556
At 31 December	<u>-</u>	<u>(3,352)</u>	<u>(3,352)</u>
Net book value at 31 December	<u>20,496</u>	<u>504</u>	<u>21,000</u>
Representing:			
- measure at cost	-	504	504
- measure at valuation	<u>20,496</u>	<u>-</u>	<u>20,496</u>
	<u>20,496</u>	<u>504</u>	<u>21,000</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

37 Premises, plant and equipment (continued)

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

	Premises	Plant and equipment	Group Total
2012			
Cost or valuation:			
At 1 January	17,377	3,686	21,063
Additions	-	214	214
Disposals	-	(107)	(107)
Elimination of accumulated depreciation on revalued premises	(497)	-	(497)
Surplus on revaluation:			
- credited to premises revaluation reserve	2,222	-	2,222
Transfer to assets held for sale	(322)	-	(322)
Transfer to investment property (note 36(a))	(32)	-	(32)
Other	-	(42)	(42)
At 31 December	<u>18,748</u>	<u>3,751</u>	<u>22,499</u>
Accumulated depreciation:			
At 1 January	(7)	(3,073)	(3,080)
Charge for the year (note 13)	(492)	(270)	(762)
Written off on disposal	-	100	100
Transfer to assets held for sale	2	-	2
Elimination of accumulated depreciation on revalued premises	497	-	497
Other	-	6	6
At 31 December	<u>-</u>	<u>(3,237)</u>	<u>(3,237)</u>
Net book value at 31 December	<u>18,748</u>	<u>514</u>	<u>19,262</u>
Representing:			
- measure at cost	-	514	514
- measure at valuation	<u>18,748</u>	<u>-</u>	<u>18,748</u>
	<u>18,748</u>	<u>514</u>	<u>19,262</u>
Bank			
	Premises	Plant and equipment	Total
2013			
Cost or valuation:			
At 1 January	13,810	3,150	16,960
Additions	-	152	152
Disposals	-	(97)	(97)
Elimination of accumulated depreciation on revalued premises	(421)	-	(421)
Surplus on revaluation:			
- credited to premises revaluation reserve	1,558	-	1,558
- debited to income statement	(3)	-	(3)
Transfer from investment property (note 36(a))	147	-	147
Other	(3)	-	(3)
At 31 December	<u>15,088</u>	<u>3,205</u>	<u>18,293</u>
Accumulated depreciation:			
At 1 January	-	(2,825)	(2,825)
Charge for the year	(421)	(148)	(569)
Written off on disposal	-	94	94
Elimination of accumulated depreciation on revalued premises	421	-	421
At 31 December	<u>-</u>	<u>(2,879)</u>	<u>(2,879)</u>
Net book value at 31 December	<u>15,088</u>	<u>326</u>	<u>15,414</u>
Representing:			
- measure at cost	-	326	326
- measure at valuation	<u>15,088</u>	<u>-</u>	<u>15,088</u>
	<u>15,088</u>	<u>326</u>	<u>15,414</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

37 Premises, plant and equipment (continued)

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

	Premises	Plant and equipment	Bank	Total
2012				
Cost or valuation:				
At 1 January	12,812	3,161	15,973	
Additions	-	122	122	
Disposals	-	(91)	(91)	
Elimination of accumulated depreciation on revalued premises	(375)	-	(375)	
Surplus on revaluation:				
- credited to premises revaluation reserve	1,468	-	1,468	
Transfer to assets held for sale	(132)	-	(132)	
Transfer from investment property (note 36(a))	37	-	37	
Other	-	(42)	(42)	
At 31 December	<u>13,810</u>	<u>3,150</u>	<u>16,960</u>	
Accumulated depreciation:				
At 1 January	-	(2,724)	(2,724)	
Charge for the year	(375)	(197)	(572)	
Written off on disposal	-	90	90	
Elimination of accumulated depreciation on revalued premises	375	-	375	
Other	-	6	6	
At 31 December	<u>-</u>	<u>(2,825)</u>	<u>(2,825)</u>	
Net book value at 31 December	<u>13,810</u>	<u>325</u>	<u>14,135</u>	
Representing:				
- measure at cost	-	325	325	
- measure at valuation	<u>13,810</u>	<u>-</u>	<u>13,810</u>	
	<u>13,810</u>	<u>325</u>	<u>14,135</u>	

(b) Terms of lease

The net book value of premises comprises:

	Group	Bank	
	2013	2012	2013
Leaseholds			
Held in Hong Kong:			
- long leases (over 50 years unexpired)	2,367	1,801	1,836
- medium leases (10 to 50 years unexpired)	17,252	16,140	13,250
- short leases (under 10 years unexpired)	-	-	-
Held outside Hong Kong:			
- long leases (over 50 years unexpired)	10	9	-
- medium leases (10 to 50 years unexpired)	867	798	2
	<u>20,496</u>	<u>18,748</u>	<u>15,088</u>
			2012
			13,810

(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	
	2013	2012	2013
Cost less accumulated depreciation			
at 31 December	<u>2,998</u>	<u>2,884</u>	<u>1,408</u>
			2012
			1,302

NOTES TO THE FINANCIAL STATEMENTS (continued)

37 Premises, plant and equipment (continued)

(d) Fair value measurement of properties

(i) Fair value hierarchy

The following table presents the fair value of the Group's properties measured at the end of the reporting period on a recurring basis, categorised into the three-level fair value hierarchy as defined in HKFRS 13, Fair value measurement. The level into which a fair value measurement is classified is determined with reference to the observability and significance of the inputs used in the valuation technique as follows:

Level 1: Fair value measured using unadjusted quoted prices in active markets for identical assets or liabilities at the measurement date.

Level 2: Fair value measured using observable inputs and not using significant unobservable inputs. Unobservable inputs are inputs for which market data are not available.

Level 3: Fair value measured using significant unobservable inputs.

	Fair value at 31 December 2013	market price Level 1	quoted inputs Level 2	using observable inputs Level 2	with significant unobservable inputs Level 3
Group					
Recurring fair value measurement					
Investment properties	10,918		-	-	10,918
Properties held for own use					
- held in Hong Kong	19,619		-	-	19,619
- held outside Hong Kong	877		-	-	877
Bank					
Recurring fair value measurement					
Investment properties	6,878		-	-	6,878
Properties held for own use					
- held in Hong Kong	15,086		-	-	15,086
- held outside Hong Kong	2		-	-	2

During the year ended 31 December 2013, there were no transfers between Level 1 and Level 2, or transfers into or out of Level 3. Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2013, and were updated for any material changes in the valuation as at 31 December 2013. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors in accordance with the HKIS Valuation Standards published by the Hong Kong Institute of Surveyors.

The fair value of investment properties is determined using Investment Approach on the basis of capitalisation of net incomes with due allowance for outgoings and reversionary income potential.

The fair values of the majorities of properties owned and occupied by the Group in Hong Kong and the PRC are determined using Direct Comparison Approach assuming sale with immediate vacant possession and by making reference to comparable sales evidence.

For properties with development potentials, their values are on redevelopment basis and reported upon the assessment on the basis that each of these properties will be developed to its full potential and completed to a good standard. The fair values are determined using Direct Comparison Approach by making reference to comparable sales transactions as available in the relevant market and have also taken into account the development costs that will be expended to complete the development.

NOTES TO THE FINANCIAL STATEMENTS (continued)

37 Premises, plant and equipment (continued)

(d) Fair value measurement of properties (continued)

(i) Fair value hierarchy (continued)

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 properties, measured at fair value using a valuation technique with significant unobservable inputs:

	Group		
	Investment properties	Properties held for own use held in Hong Kong	Properties held for own use outside Hong Kong
At 1 January 2013	4,860	17,941	807
Additions	4,867	-	34
Depreciation for the year	-	(528)	(28)
Surplus on revaluation:			
- credited to premises revaluation reserve	-	2,065	38
- credited/(debited) to income statement	1,338	(3)	-
Transfer	(147)	147	-
Exchange adjustments and other	-	(3)	26
At 31 December 2013	10,918	19,619	877

Unrealised gains or losses recognised in profit or loss relating to those assets held at the end of the reporting period

- other operating income	280	-	-
- Net surplus on property revaluation	1,058	(3)	-
- Depreciation of premises, plant and equipment	-	(528)	(28)

	Bank		
	Investment properties	Properties held for own use held in Hong Kong	Properties held for own use outside Hong Kong
At 1 January 2013	2,988	13,808	2
Additions	3,228	-	-
Depreciation for the year	-	(421)	-
Surplus on revaluation:			
- credited to premises revaluation reserve	-	1,558	-
- credited/(debited) to income statement	809	(3)	-
Transfer	(147)	147	-
Exchange adjustments and other	-	(3)	-
At 31 December 2013	6,878	15,086	2

Unrealised gains or losses recognised in profit or loss relating to those assets held at the end of the reporting period

- other operating income	-	-	-
- Net surplus on property revaluation	809	(3)	-
- Depreciation of premises, plant and equipment	-	(421)	-

NOTES TO THE FINANCIAL STATEMENTS (continued)

37 Premises, plant and equipment (continued)

(d) Fair value measurement of properties (continued)

(ii) Information about Level 3 fair value measurements

	Valuation technique(s)	Unobservable input(s)	Range
Investment properties	Investment approach	Market yields (reversionary yield)	3 % to 5.6 %
Premises held for own use	Direct comparison approach	Market rental Premium (discount) on characteristic of the properties	HK\$15 to HK\$1,014 per square foot -20% to 20%

The fair value of investment properties is determined using investment approach on the basis of capitalisation of net incomes with due allowance of outgoings and reversionary income potential. The fair value measurement is positively correlated to the market rental but inversely correlated to the market yields.

The fair value of premises held for own use are determined using direct comparison approach to value these properties in their respective existing states and uses on the market basis assuming sale with immediate vacant possession and by making reference to comparable sales evidence. The valuations take into account the characteristic of the properties which included the location, size, shape, view, floor level, year of completion and others factors collectively. Higher premium for properties with higher characteristic will result in a higher fair value measurement.

38 Intangible assets

	Group		Bank	
	2013	2012	2013	2012
Present value of in-force long-term insurance business	7,198	6,003	-	-
Internally developed software	378	400	378	400
Acquired software	69	51	3	6
Goodwill	329	329	-	-
	7,974	6,783	381	406

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

	Group	
	2013	2012
At 1 January	6,003	5,188
Addition from current year new business	1,436	1,198
Movement from in-force business	(241)	(383)
At 31 December	7,198	6,003

The key assumptions used in the computation of "PVIF" are as follows:

	2013	2012
Risk discount rate	6.2%	6.3%
Expenses inflation	3.0%	3.0%
Average lapse rate:		
- 1st year	2.7%	2.7%
- 2nd year onwards	0.5%	0.5%

The sensitivity of PVIF valuation to changes in individual assumptions at the balance sheet dates is shown in Management Discussion and Analysis.

NOTES TO THE FINANCIAL STATEMENTS (continued)

38 Intangible assets (continued)

(b) Goodwill

	Group	Bank	
	2013	2012	2013
At 1 January and at 31 December	<u>329</u>	<u>329</u>	-

Goodwill arising from acquisition of the remaining 50 per cent of Hang Seng Life Limited from HSBC Insurance (Asia-Pacific) Holdings Limited amounted to HK\$329 million is allocated to cash-generating units of Life Insurance - Hang Seng Insurance Company Limited ("HSIC") for the purpose of impairment testing.

During 2013, there was no impairment of goodwill (2012: 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 2013, the PVIF and the expected value of future business. The PVIF 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 note 38(a) and Management Discussion and Analysis.

(c) Movement of internally developed application software and acquired software

	Group	Bank	
	2013	2012	2013
Cost:			
At 1 January	1,090	978	1,014
Additions	124	145	91
Disposals	(25)	(75)	(24)
Written off	(13)	-	(13)
Exchange and others	2	42	-
At 31 December	1,178	1,090	1,068
Accumulated amortisation:			
At 1 January	(639)	(533)	(608)
Charge for the year (note 13)	(113)	(115)	(99)
Written off on disposal	22	15	20
Exchange and others	(1)	(6)	-
At 31 December	(731)	(639)	(687)
Net book value at 31 December	447	451	381
			406

During 2013, there was impairment on internally developed application software and acquired software of HK\$13 million (2012: nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

39 Other assets

	Group		Bank	
	2013	2012 (restated)	2013	2012 (restated)
Items in the course of collection from other banks	4,743	5,642	4,742	5,642
Bullion	4,184	6,576	4,184	6,547
Prepayments and accrued income	3,519	2,999	1,539	966
Assets held for sale*				
- reposessed assets	9	16	8	14
- other assets held for sale	-	593	-	406
Acceptances and endorsements	6,351	5,264	3,254	2,548
Retirement benefit assets	40	31	40	31
Other accounts	3,559	2,036	1,040	659
	22,405	23,157	14,807	16,813

* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2013 and 2012.

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

Gold bullion balances were reclassified from "Cash and balances with banks" to "Other assets" during the year to reflect better the substance of the gold lending business.

40 Current, savings and other deposit accounts

	Group		Bank	
	2013	2012	2013	2012
Current, savings and other deposit accounts:				
- as stated in balance sheet	824,996	769,147	774,462	730,533
- structured deposits reported as trading liabilities (note 41)	34,489	38,113	2,286	6,036
	859,485	807,260	776,748	736,569
By type:				
- demand and current accounts	74,664	68,071	74,662	68,071
- savings accounts	526,403	495,880	509,393	483,700
- time and other deposits	258,418	243,309	192,693	184,798
	859,485	807,260	776,748	736,569

41 Trading liabilities

	Group		Bank	
	2013	2012	2013	2012
Structured certificates of deposit in issue (note 43)	-	-	-	-
Other structured debt securities in issue (note 43)	1,615	248	1,615	248
Structured deposits (note 40)	34,489	38,113	2,286	6,036
Short positions in securities and others	26,013	21,492	26,013	21,492
	62,117	59,853	29,914	27,776

NOTES TO THE FINANCIAL STATEMENTS (continued)

42 Financial liabilities designated at fair value

	Group		Bank	
	2013	2012	2013	2012
Liabilities to customers under investment contracts	489	464	-	-

43 Certificates of deposit and other debt securities in issue

	Group		Bank	
	2013	2012	2013	2012
Certificates of deposit and other debt securities in issue:				
- as stated in balance sheet	8,601	11,291	8,601	11,291
- structured certificates of deposit in issue reported as trading liabilities (note 41)	-	-	-	-
- other structured debt securities in issue reported as trading liabilities (note 41)	1,615	248	1,615	248
	10,216	11,539	10,216	11,539
By type:				
- certificates of deposit in issue	8,601	11,291	8,601	11,291
- other debt securities in issue	1,615	248	1,615	248
	10,216	11,539	10,216	11,539

44 Other liabilities

	Group		Bank	
	2013	2012	2013	2012
Items in the course of transmission to other banks	6,987	8,153	6,986	8,148
Accruals	3,330	3,248	2,192	2,245
Acceptances and endorsements	6,351	5,264	3,254	2,548
Retirement benefit liabilities	1,772	2,448	1,772	2,448
Others	2,027	2,540	1,598	2,100
	20,467	21,653	15,802	17,489

NOTES TO THE FINANCIAL STATEMENTS (continued)

45 Liabilities to customers under insurance contracts

	Group			2012		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
Non-life insurance						
Unearned premiums	-	-	-	-	-	-
Notified claims	-	-	-	-	-	-
Claims incurred but not reported	-	-	-	-	-	-
Other	-	-	-	-	-	-
Policyholders' liabilities						
Life (non-linked)	85,756	(1,446)	84,310	81,579	(414)	81,165
Life (linked)	88	-	88	91	-	91
	85,844	(1,446)	84,398	81,670	(414)	81,256
	85,844	(1,446)	84,398	81,670	(414)	81,256

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
2013			
Unearned premiums			
At 1 January	-	-	-
Gross written premiums	-	-	-
Gross earned premiums	-	-	-
Exchange and other movements	-	-	-
At 31 December	<u>-</u>	<u>-</u>	<u>-</u>
Notified and incurred but not reported claims			
At 1 January			
- notified claims			
- claims incurred but not reported			
Claims paid			
Claims incurred			
Exchange and other movements	-	-	-
At 31 December			
- notified claims			
- claims incurred but not reported			
Other			
	<u>-</u>	<u>-</u>	<u>-</u>
	<u>-</u>	<u>-</u>	<u>-</u>
	<u>-</u>	<u>-</u>	<u>-</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

45 Liabilities to customers under insurance contracts (continued)

(a) Non-life insurance (continued)

	Group		
	Gross	Reinsurance	Net
2012			
Unearned premiums			
At 1 January	245	(77)	168
Gross written premiums	221	(46)	175
Gross earned premiums	(228)	55	(173)
Exchange and other movements	(238)	68	(170)
At 31 December	-	-	-
Notified and incurred but not reported claims			
At 1 January			
- notified claims	183	(27)	156
- claims incurred but not reported	37	(8)	29
	220	(35)	185
Claims paid	(61)	15	(46)
Claims incurred	72	(16)	56
	11	(1)	10
Exchange and other movements	(231)	36	(195)
At 31 December			
- notified claims	-	-	-
- claims incurred but not reported	-	-	-
	-	-	-
Other			
	-	-	-
	-	-	-
	-	-	-

(b) Policyholders' liabilities

	Group		
	Gross	Reinsurance	Net
2013			
Life (non-linked)			
At 1 January	81,579	(414)	81,165
Benefits paid	(8,803)	42	(8,761)
Claims incurred and movement in policyholders' liabilities	12,843	(1,078)	11,765
Exchange and other movements	137	4	141
At 31 December	85,756	(1,446)	84,310
Life (linked)			
At 1 January	91	-	91
Benefits paid	(12)	-	(12)
Claims incurred and movement in policyholders' liabilities	9	-	9
Exchange and other movements	-	-	-
At 31 December	88	-	88
	85,844	(1,446)	84,398

NOTES TO THE FINANCIAL STATEMENTS (continued)

45 Liabilities to customers under insurance contracts (continued)

(b) Policyholders' liabilities (continued)

	Group		
2012	Gross	Reinsurance	Net
Life (non-linked)			
At 1 January	71,523	(42)	71,481
Benefits paid	(2,465)	36	(2,429)
Claims incurred and movement in policyholders' liabilities	12,576	(414)	12,162
Exchange and other movements	(55)	6	(49)
At 31 December	<u>81,579</u>	<u>(414)</u>	<u>81,165</u>
Life (linked)			
At 1 January	183	-	183
Benefits paid	(108)	-	(108)
Claims incurred and movement in policyholders' liabilities	17	-	17
Exchange and other movements	(1)	-	(1)
At 31 December	<u>91</u>	<u>-</u>	<u>91</u>
	<u>81,670</u>	<u>(414)</u>	<u>81,256</u>

46 Current tax and deferred tax

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

	Group		Bank	
	2013	2012	2013	2012
Included in "Other assets":				
Current taxation recoverable	82	21	-	-
Deferred tax assets	43	-	-	-
	<u>125</u>	<u>21</u>	<u>-</u>	<u>-</u>
Current tax liabilities:				
Provision for Hong Kong profits tax	675	576	650	499
Provision for taxation outside Hong Kong	17	12	12	10
	<u>692</u>	<u>588</u>	<u>662</u>	<u>509</u>
Deferred tax liabilities	3,850	4,323	1,985	1,687
	<u>4,542</u>	<u>4,911</u>	<u>2,647</u>	<u>2,196</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

46 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 sheet and the movements during the year are as follows:

	Group						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available-for-sale financial assets	Cash flow hedge	Other	Total
2013							
At 1 January	79	2,702	(87)	9	3	1,617	4,323
Charged/(credited) to income statement (note 19(a))	24	(32)	5	-	-	(919)	(922)
Charged to reserves	-	337	-	(57)	(2)	128	406
At 31 December	103	3,007	(82)	(48)	1	826	3,807

2012 (restated)							
At 1 January	93	2,410	(88)	(31)	1	993	3,378
(Credited)/charged to income statement (note 19(a))	(14)	(66)	1	-	-	506	427
Charged to reserves	-	358	-	41	2	120	521
Exchange and others	-	-	-	(1)	-	(2)	(3)
At 31 December	79	2,702	(87)	9	3	1,617	4,323

	Bank						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available-for-sale financial assets	Cash flow hedge	Other	Total
2013							
At 1 January	74	2,135	(76)	5	3	(454)	1,687
Charged/(credited) to income statement	18	(64)	5	-	-	(8)	(49)
Charged to reserves	-	232	-	(11)	(2)	128	347
At 31 December	92	2,303	(71)	(6)	1	(334)	1,985

2012 (restated)							
At 1 January	92	1,950	(87)	(34)	1	(580)	1,342
(Credited)/charged to income statement	(18)	(58)	11	-	-	7	(58)
Charged to reserves	-	243	-	39	2	119	403
At 31 December	74	2,135	(76)	5	3	(454)	1,687

(c) Deferred tax assets not recognised

At the balance sheet date, the Group has not recognised deferred tax assets in respect of tax losses amounting to HK\$34 million (2012: HK\$33 million) which are considered unlikely to be utilised. The unrecognised deferred tax assets of HK\$34 million (2012: HK\$33 million) have no expiry date.

(d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised as at 31 December 2013 (31 December 2012: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

47 Subordinated liabilities

Nominal value	Description	Group		Bank	
		2013	2012	2013	2012
Amount owed to HSBC Group undertakings					
US\$775 million	Floating rate subordinated loan debt due December 2020 ¹	6,009	6,007	6,009	6,007
US\$450 million	Floating rate subordinated loan debt due July 2021 ²	3,489	3,488	3,489	3,488
US\$300 million	Floating rate subordinated loan debt due July 2022 ³	2,326	2,326	2,326	2,326
		<u>11,824</u>	<u>11,821</u>	<u>11,824</u>	<u>11,821</u>
Representing: - measured at amortised cost		<u>11,824</u>	<u>11,821</u>	<u>11,824</u>	<u>11,821</u>

¹ Interest rate at three-month US dollar LIBOR plus 1.79 per cent, payable quarterly, to the maturity date.

² Interest rate at three-month US dollar LIBOR plus 2.05 per cent, payable quarterly, to the maturity date.

³ Interest rate at three-month US dollar LIBOR plus 4.06 per cent, payable quarterly, to the maturity date.

The outstanding subordinated loan debts serve to help the Bank maintain a balanced capital structure and support business growth.

The Group has not had any defaults of principal, interest or other breaches with respect to its debt securities during the years 2013 and 2012.

48 Share capital

Authorised:

The authorised share capital of the Bank is HK\$11,000 million (2012: HK\$11,000 million) divided into 2,200 million shares (2012: 2,200 million shares) of HK\$5 each.

	2013	2012
Issued and fully paid: 1,911,842,736 shares (2012: 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 (2012: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

49 Reserves

The reconciliation between the opening and closing balances of each component of the Group's consolidated equity is set out in the consolidated statement of changes in equity.

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 realised profits which can be distributed to shareholders.

Regulatory reserve

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a "regulatory reserve" from retained profits. Movements in the reserve are made directly through retained earnings. As at 31 December 2013, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group and the Bank to shareholders by HK\$5,440 million (2012: HK\$4,866 million) and HK\$4,904 million (2012: HK\$4,497 million) respectively.

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.

There is no premises revaluation reserve related to premises classified as assets held for sale, included in "Other assets" in the consolidated balance sheet at 31 December 2013 (31 December 2012: HK\$216 million).

Cash flow hedging reserve

The cash flow hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions.

Available-for-sale investment reserve

The available-for-sale investment reserve includes the cumulative net change in the fair value of available-for-sale investments other than impairments which have been recognised in the income statement.

Capital redemption reserve

Capital redemption reserve represents the difference between the capital payment and the nominal value of the redeemed share capital.

Other reserves

Other reserves comprise foreign exchange reserve and share-based payment reserve. 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.

NOTES TO THE FINANCIAL STATEMENTS (continued)

49 Reserves (continued)

Details of the changes in the Bank's individual components of equity between the beginning and the end of the year are set out below:

	Bank	
	2013	2012
Retained profits (including proposed dividends)	64,473	31,888
Premises revaluation reserve	11,654	10,802
Cash flow hedging reserve	6	17
Available-for-sale investment reserve:		
- on debt securities	(30)	27
- on equity securities	(1,776)	68
Capital redemption reserve	99	99
Other reserves	662	631
Total reserves (including proposed dividends)	<u><u>75,088</u></u>	<u><u>43,532</u></u>
 <i>Retained profits (including proposed dividends)</i>		
At beginning of the year	31,888	26,910
Dividends to shareholders:		
- dividends approved in respect of the previous year	(3,824)	(3,633)
- dividends declared in respect of the current year	(6,309)	(6,309)
Transfer	474	298
Total comprehensive income for the year	<u><u>42,244</u></u>	<u><u>14,622</u></u>
	<u><u>64,473</u></u>	<u><u>31,888</u></u>
 <i>Premises revaluation reserve</i>		
At beginning of the year	10,802	9,871
Transfer	(474)	(298)
Total comprehensive income for the year	<u><u>1,326</u></u>	<u><u>1,229</u></u>
	<u><u>11,654</u></u>	<u><u>10,802</u></u>
 <i>Cash flow hedging reserve</i>		
At beginning of the year	17	6
Total comprehensive income for the year	<u><u>(11)</u></u>	<u><u>11</u></u>
	<u><u>6</u></u>	<u><u>17</u></u>
 <i>Available-for-sale investment reserve</i>		
At beginning of the year	95	(164)
Total comprehensive income for the year	<u><u>(1,901)</u></u>	<u><u>259</u></u>
	<u><u>(1,806)</u></u>	<u><u>95</u></u>
 <i>Capital redemption reserve</i>		
At beginning of the year	99	99
Total comprehensive income for the year	<u><u>-</u></u>	<u><u>-</u></u>
	<u><u>99</u></u>	<u><u>99</u></u>
 <i>Other reserve</i>		
At beginning of the year	631	585
Costs of share-based payment arrangements	30	47
Total comprehensive income for the year	<u><u>1</u></u>	<u><u>(1)</u></u>
	<u><u>662</u></u>	<u><u>631</u></u>
 Total reserves (including proposed dividends)	<u><u>75,088</u></u>	<u><u>43,532</u></u>

At 31 December 2013, the aggregate amount of reserves available for distribution to equity shareholders of the Bank as calculated under the provision of section 79B of the Hong Kong Companies Ordinance amounted to HK\$31,788 million (2012: HK\$24,773 million). After considering regulatory capital requirement and business development needs, an amount of HK\$4,206 million has been declared as the proposed fourth interim dividends in respect of the financial year ended 31 December 2013 (2012: HK\$3,824 million). The difference between the aggregate distributable reserves of HK\$31,788 million and the Bank's retained profit of HK\$64,473 million as reported above mainly represents the exclusion of unrealised revaluation gain on investment properties, the regulatory reserve of the Bank and the accounting gain upon derecognition of Industrial Bank as an associate in January 2013.

NOTES TO THE FINANCIAL STATEMENTS (continued)

50 Reconciliation of cash flow statement

(a) Reconciliation of operating profit to net cash flow from operating activities

	2013	2012 (restated)
Operating profit	18,410	15,487
Net interest income	(18,604)	(16,946)
Dividend income	(1,014)	(17)
Loan impairment charges	536	386
Impairment loss of intangible assets	13	-
Depreciation	762	762
Amortisation of intangible assets	113	115
Amortisation of available-for-sale investments	67	(47)
Amortisation of held-to-maturity debt securities	1	1
Loans and advances written off net of recoveries	(495)	(633)
Movement in present value of in-force long-term insurance business	(1,195)	(815)
Interest received	22,760	20,086
Interest paid	(4,999)	(4,567)
Operating profit before changes in working capital	16,355	13,812
Change in treasury bills and certificates of deposit with original maturity more than three months	5,631	(39,942)
Change in placings with and advances to banks maturing after one month	(3,271)	(11,989)
Change in trading assets	4,705	10,132
Change in financial assets designated at fair value	-	140
Change in derivative financial instruments	(339)	(1,199)
Change in loans and advances to customers	(50,676)	(55,425)
Change in other assets	(1,846)	(10,724)
Change in current, savings and other deposit accounts	55,832	69,290
Change in deposits from banks	(8,019)	5,841
Change in trading liabilities	2,264	141
Change in certificates of deposit and other debt securities in issue	(2,690)	2,007
Change in other liabilities	3,020	9,737
Elimination of exchange differences and other non-cash items	4,832	2,228
Cash generated from/(used in) operating activities	25,798	(5,951)
Taxation paid	(2,696)	(1,954)
Net cash inflow/(outflow) from operating activities	23,102	(7,905)

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

	2013	2012 (restated)
Cash and balances with banks	33,294	20,506
Items in the course of collection from other banks	4,743	5,642
Placings with and advances to banks maturing within one month	62,043	74,552
Treasury bills	22,686	22,090
Certificates of deposit	-	1,310
Less: items in the course of transmission to other banks	(6,987)	(8,153)
	115,779	115,947

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\$24,795 million at 31 December 2013 (31 December 2012: HK\$18,881 million).

NOTES TO THE FINANCIAL STATEMENTS (continued)

51 Contingent liabilities and commitments

(a) Off-balance sheet contingent liabilities and commitments

The tables below give the contract amounts, credit equivalent amounts and risk-weighted amounts of off-balance sheet transactions. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

For the purposes of these financial statements, acceptances and endorsements are recognised on the 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\$6,351 million (2012: HK\$5,264 million) and HK\$3,254 million (2012: HK\$2,548 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.

The risk-weighted assets at balance sheet dates were calculated based on the "Advanced internal ratings-based approach".

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2013						
Direct credit substitutes	8,977	8,184	4,807	5,185	4,860	2,841
Transaction-related contingencies	1,821	187	131	1,765	183	132
Trade-related contingencies	14,922	1,630	922	10,922	1,221	627
Forward asset purchases	43	43	43	43	43	43
Undrawn formal standby facilities, credit lines and other commitments to lend:						
- not unconditionally cancellable*	28,343	13,947	6,102	31,468	15,825	5,994
- unconditionally cancellable	243,895	77,069	18,813	216,902	72,337	14,882
	298,001	101,060	30,818	266,285	94,469	24,519

NOTES TO THE FINANCIAL STATEMENTS (continued)

51 Contingent liabilities and commitments (continued)

(a) Off-balance sheet contingent liabilities and commitments (continued)

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2012						
Direct credit substitutes	7,259	7,041	3,805	5,233	5,016	2,284
Transaction-related contingencies	1,250	128	54	1,211	130	59
Trade-related contingencies	11,548	1,181	696	8,456	870	465
Forward asset purchases	51	51	51	51	51	51
Undrawn formal standby facilities, credit lines and other commitments to lend:						
- not unconditionally cancellable*	33,261	15,258	6,189	35,913	17,274	5,838
- unconditionally cancellable	247,891	82,049	24,909	216,597	75,317	18,570
	<u>301,260</u>	<u>105,708</u>	<u>35,704</u>	<u>267,461</u>	<u>98,658</u>	<u>27,267</u>

* The contract amount for undrawn formal standby facilities, credit lines and other commitments to lend with original maturity of "up to one year" and "over one year" as at 31 December 2013 were HK\$3,723 million and HK\$24,620 million respectively (31 December 2012: HK\$8,336 million and HK\$24,925 million).

(b) Contingencies

There is no material litigation expected to result in a significant adverse effect on the financial position of the Group and the Bank, either collectively or individually. Management believes that adequate provisions have been made in respect of such litigation.

52 Assets pledged as security for liabilities and collateral accepted as security for assets

	Group		Bank	
	2013	2012	2013	2012
Assets pledged to secure liabilities				
Financial assets ¹ pledged to secure liabilities	24,879	21,073	24,879	21,073
Liabilities secured by financial assets	24,689	21,006	24,689	21,006
Collateral accepted as security for assets				
Fair value of the collateral permitted to sell or repledge in the absence of default ²	-	-	-	-
Fair value of collateral actually sold or repledged	-	-	-	-

1 Financial assets comprise trading assets and financial investments.

2 These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements. The group is obliged to return equivalent securities.

53 Capital commitments

	Group		Bank	
	2013	2012	2013	2012
Expenditure authorised and contracted for	<u>414</u>	<u>1,736</u>	<u>393</u>	<u>230</u>
Expenditure authorised but not contracted for	<u>-</u>	<u>1</u>	<u>-</u>	<u>-</u>

NOTES TO THE FINANCIAL STATEMENTS (continued)

54 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	
	2013	2012	2013	2012
Within one year	613	567	468	435
Between one and five years	645	699	485	566
Over five years	59	2	14	-
	1,317	1,268	967	1,001

55 Employee retirement benefits

(a) Defined benefit schemes

(i) Total defined benefit recognised in the income statement

Included within "Employee compensation and benefits" are components of expense related to the Group's defined benefit schemes, as follows:

	Group and Bank	
	2013	2012 (restated)
Defined benefit schemes		
- Current service cost	294	319
- Net interest expense on the net defined benefit liability/asset	14	40
- Administrative costs and taxes paid by scheme*	2	-
Total expense (note 13)	310	359

* Amounts previously disclosed within current service cost are disclosed separately under the requirements of HKAS 19 revised.

(ii) Cumulative actuarial gains/(losses) recognised in other comprehensive income in respect of defined benefit schemes

	Group and Bank	
	2013	2012 (restated)
At 1 January		
Actuarial gains recognised in other comprehensive income	(2,803)	(3,527)
At 31 December	778	724
	(2,025)	(2,803)

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 35 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS were closed to new entrants with effect from 31 December 1986. Since the defined benefit section of the HSBDBS is a final salary lump sum scheme, its exposure to longevity risk and interest rate risk is limited.

These schemes are registered under Occupational Retirement Schemes Ordinance (Cap. 426 of the law of Hong Kong) ("the Ordinance"). These schemes are administered by trustees, the majority of which are independent, with their assets held separately from those of the Group. The trustees are required by the Trust Deed to act in the best interest of the scheme participants and are responsible for setting investment policies of the schemes.

HSBDBS is predominantly a funded scheme with assets which is held under insurance policy separate from the Group. HSBDBS is reviewed at least on a triennial basis in accordance with local regulations. The actuarial assumptions used to calculate the defined benefit obligations of HSBDBS vary according to the economic conditions.

HSBDBS mainly invests in bonds and equities and each investment manager has been assigned an investment mandate with the targeted asset allocation. The ranges of target asset allocations for the portfolio are as follows: Bonds (0 – 50%), Equity (0 – 50%) and cash (0 – 100 %).

NOTES TO THE FINANCIAL STATEMENTS (continued)

55 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

(iii) Movements in the scheme assets and present value of the defined benefit obligations

Net asset/(liability) under defined benefit schemes

	Group and Bank		
	Fair value of scheme assets	Present value of defined benefit obligations	Net defined benefit liability
At 1 January 2013	4,613	(7,030)	(2,417)
Current service cost	-	(294)	(294)
Net interest income/(cost) on the net defined benefit liability	28	(42)	(14)
Remeasurement effects recognised in other comprehensive income	165	613	778
- Actuarial gains from changes in financial assumptions	-	604	604
- Actuarial gains from experience	165	9	174
Contributions by the Group	217	-	217
Benefits paid	(361)	361	-
Administrative costs and taxes paid by scheme	(2)	-	(2)
At 31 December 2013	<u>4,660</u>	<u>(6,392)</u>	<u>(1,732)</u>
Retirement benefit liabilities recognised on the balance sheet (included in "Other liabilities")	4,431	(6,203)	(1,772)
Retirement benefit assets recognised on the balance sheet (included in "Other assets")	229	(189)	40
Present value of defined benefit obligation relating to:			
- Actives			6,205
- Pensioners			187

NOTES TO THE FINANCIAL STATEMENTS (continued)

55 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

(iii) Movements in the scheme assets and present value of the defined benefit obligations (continued)

Net asset/(liability) under defined benefit schemes (continued)

	Fair value of scheme assets	Present value of defined benefit obligations (restated)	Net defined benefit liability (restated)	Group and Bank
At 1 January 2012	4,042	(7,268)	(3,226)	
Current service cost	-	(319)	(319)	
Net interest income/(cost) on the net defined benefit liability	184	(224)	(40)	
Remeasurement effects recognised in other comprehensive income	341	383	724	
- Actuarial gains from changes in financial assumptions	-	229	229	
- Actuarial gains from experience	341	154	495	
Contributions by the Group	444	-	444	
Benefits paid	(398)	398	-	
At 31 December 2012	<u>4,613</u>	<u>(7,030)</u>	<u>(2,417)</u>	
Retirement benefit liabilities recognised on the balance sheet (included in "Other liabilities")	4,582	(7,030)	(2,448)	
Retirement benefit assets recognised on the balance sheet (included in "Other assets")	31	-	31	
Present value of defined benefit obligation relating to:				
- Actives	6,806			
- Pensioners	224			

The Group and the Bank expect to make HK\$287 million of contributions to defined benefit pension schemes during 2014.

(iv) Benefits expected to be paid

Benefits expected to be paid from the HSBDBS, HSBPS and HSBNTBS to retirees over each of the next five years, and in aggregate for the five years thereafter, are as follows:

	2014	2015	2016	2017	2018	2019-2023
HSBDBS	363	376	409	519	500	3,042
HSBPS / HSBNTBS	15	14	14	13	13	55

The duration of the principal scheme HSBDBS is 9 years under the disclosure assumptions adopted.

NOTES TO THE FINANCIAL STATEMENTS (continued)

55 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

(v) Fair value of scheme assets by asset classes

Group and Bank			
	Value	Quoted market price in active market	Of which held by the Group
2013			
Fair value of scheme assets			
- Equities	2,056	2,056	-
- Bonds	2,069	2,069	-
- Other*	535	535	38
	4,660	4,660	38
2012			
Fair value of scheme assets			
- Equities	1,483	1,483	-
- Bonds	2,721	2,721	-
- Other*	409	409	43
	4,613	4,613	43

* Other mainly consists of cash and deposits.

(vi) The Principal Scheme's actuarial financial assumptions

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The latest annual actuarial valuations at 31 December 2013 were performed by T Ching, fellow of the Society of Actuaries of the United States of America, of HSBC Insurance (Asia) Limited, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method.

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.

On an on-going basis, the value of the principal scheme assets of HSBDBS represented 94 per cent (2012: 98 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting deficit amounted to HK\$283 million (deficit in 2012: HK\$88 million). On a wind-up basis, the actuarial value of the HSBDBS assets represented 101 per cent (2012: 102 per cent) of the members' vested benefits, based on salaries at that date, and the resulting surplus amounted to HK\$37 million (surplus in 2012: HK\$86 million).

The determinations for actuarial funding valuation purposes are based on different methods and assumptions from those used for financial reporting purposes, and as a result should neither be compared nor related to other determinations included in these financial statements.

NOTES TO THE FINANCIAL STATEMENTS (continued)

55 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

(vi) The Principal Scheme's actuarial financial assumptions (continued)

The present value of the principal scheme's obligation was a final lump sum salary of HK\$6,203 million (2012: HK\$6,805 million). The principal actuarial assumptions used to calculate the Group's obligations for the HSBDBS for each year, and used as the basis for measuring the expenses in relation to the scheme, were as follows:

Principal actuarial assumptions for the principal scheme

	Group and Bank	HSBDBS %
2013		
Discount rate		2.15
Expected rate of salary increases		5.00
of which:		
- 2014		5.50
- thereafter		5.00
2012		
Discount rate		0.60
Expected rate of salary increases		4.50
of which:		
- 2013		4.70
- thereafter		4.50

The Group determines the discount rates to be applied to its obligations in consultation with the schemes' actuaries, on the basis of current average yields of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations. Where there is not a deep market in corporate bonds, government bond yields have been used, and this is the case for HSBDBS. The yield curve has been extrapolated where the term of the liabilities is longer than the duration of available bonds and the discount rate used then takes into account the term of the liabilities and the shape of the yield curve.

NOTES TO THE FINANCIAL STATEMENTS (continued)

55 Employee retirement benefits (continued)

(a) Defined benefit schemes (continued)

(vii) Actuarial assumption sensitivities

The discount rate and rate of pay increase are sensitive to changes in market conditions arising during the reporting year. The following table shows the effect of changes in these on the HSBDBS:

The effect of changes in key assumptions:

	HSBDBS	
	2013	2012
Discount rate		
- change in retirement benefit obligation at year end from a 25bps increase	(133)	(161)
- change in retirement benefit obligation at year end from a 25bps decrease	138	168
- change in 2014/2013 retirement benefit cost from a 25bps increase	(5)	(3)
- change in 2014/2013 retirement benefit cost from a 25bps decrease	5	2
Rate of pay increase		
- change in retirement benefit obligation at year end from a 25bps increase	134	161
- change in retirement benefit obligation at year end from a 25bps decrease	(130)	(155)
- change in 2014/2013 retirement benefit cost from a 25bps increase	9	9
- change in 2014/2013 retirement benefit cost from a 25bps decrease	(8)	(8)

(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:

	2013	2012
Amounts charged to the income statement (note 13)	<u>131</u>	<u>97</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. The forfeited contributions utilised during the year or available at the year-end to reduce future contributions is HK\$1 million (2012: Nil).

NOTES TO THE FINANCIAL STATEMENTS (continued)

56 Share-based payments

The Group participated in various share compensation plans as listed in the following tables that are operated by the HSBC Group for acquiring of HSBC Holdings plc shares. These are to be settled by the delivery of shares of HSBC Holdings plc.

Share Awards and Option Plans

<u>Award</u>	<u>Policy</u>	<u>Purpose</u>
Restricted Share Awards	<ul style="list-style-type: none"> - Vesting of awards generally subject to continued employment with the Group - Vesting often staggered over three years Certain shares subject to a retention requirement post-vesting - Awards generally not subject to performance conditions - Awards granted from 2010 onwards are subject to clawback provision prior to vesting 	<ul style="list-style-type: none"> - Rewards employee performance, potential and retention of key employees - To defer variable pay - To aid recruitment
Savings-related share award plan ("HSBC International Employee Share Purchase Plan")	<ul style="list-style-type: none"> - A new broad-based employee plan which was offered to eligible employees in Hong Kong in September 2013 - Eligible employees make contributions up to the local equivalent of £250 per month which are applied in the purchase of shares on a quarterly basis. For every three shares purchased, the employee is granted a matching award by the HSBC Group of one share - The matching award vests subject to continued employment with the Group and retention of the purchased shares in the plan until the third anniversary of the start of the relevant plan year 	<ul style="list-style-type: none"> - To align the interests of all employees with the creation of shareholder value
Savings-Related Share Option Plan	<ul style="list-style-type: none"> - 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 fifth anniversaries of the commencement of three-year or five-year contracts, respectively - The exercise price is set at a 20% (2012: 20%) discount to the market value immediately preceding the date of invitation 	<ul style="list-style-type: none"> - Eligible employees save up to £250 per month (or its equivalent in Hong Kong dollars), with the option to use the savings to acquire shares
Group Share Option Plan ("GSOP")	<ul style="list-style-type: none"> - Vesting of awards based on achievement of certain corporate performance condition targets - Exercisable between third and tenth anniversaries of the date of grant - Plan ceased in 2004 	<ul style="list-style-type: none"> - Long-term incentive plan between 2000 and 2004 during which certain employees were awarded share options

NOTES TO THE FINANCIAL STATEMENTS (continued)

56 Share-based payments (continued)

(a) Savings-Related Share Option Plan

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

Option scheme with exercise price set in Hong Kong dollars

	2013		2012	
	Weighted average exercise price HK\$	Number ('000)	Weighted average exercise price HK\$	Number ('000)
Outstanding at 1 January	46.01	7,443	41.31	10,886
Granted in the year	-	-	55.47	3,145
Exercised in the year	54.21	(1,845)	40.39	(5,429)
Lapsed in the year	46.01	(50)	41.31	(1,159)
Outstanding at 31 December	42.82	<u>5,548</u>	46.01	<u>7,443</u>
Exercisable at 31 December	-	<u><u>-</u></u>	-	<u><u>-</u></u>

The weighted average share price at the date of exercise for share options exercised during the year was HK\$85.03 (2012: HK\$67.97).

The options outstanding at the year end of 2013 had an exercise price in the range of HK\$37.88 to HK\$63.99 (2012: HK\$37.88 to HK\$63.99), and a weighted average remaining contractual life of 1.39 years (2012: 2.04 years).

No share option was granted during 2013. The weighted average fair value of options granted during 2012 was HK\$12.87.

NOTES TO THE FINANCIAL STATEMENTS (continued)

56 Share-based payments (continued)

(b) Group Share Option Plan

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

	2013		2012	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	6.88	1,144	6.95	1,671
Exercised in the year	6.15	(155)	6.02	(61)
Lapsed in the year	6.88	(195)	6.95	(466)
Outstanding at 31 December	7.22	794	6.88	1,144
Exercisable at 31 December	7.22	794	6.88	1,144

The weighted average share price at the date of exercise for share options exercised during the year was £7.11 (2012: £6.41).

The options outstanding at the year end of 2013 had an exercise price of £7.22 (2012: £6.02 to £7.22), and a weighted average remaining contractual life of 0.33 years (2012: 1.05 years).

(c) Calculation of fair value

The recognition of compensation cost of share option is based on the fair value of the options on grant date. The calculation of the fair value of HSBC share option is centrally managed by HSBC Holdings plc. Fair values of share options, measured at the date of grant of the options are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. Expected dividends are incorporated into the valuation model for share options and awards where applicable. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

No share option was granted during 2013. The significant weighted average assumptions used to estimate the fair value of the options granted during 2012 were as follows:

	1-year Savings- Related Share Option Plan	3-year Savings- Related Share Option Plan	5-year Savings- Related Share Option Plan
2012			
Risk-free interest rate (%)	0.4	0.6	1.2
Expected life (years)	1	3	5
Expected volatility (%)	25	25	25
Share price at grant date (HK\$)	68.60	68.60	68.60

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.

NOTES TO THE FINANCIAL STATEMENTS (continued)

56 Share-based payments (continued)

(d) Restricted Share Awards

	2013 Number ('000)	2012 Number ('000)
Outstanding at 1 January	334	696
Additions during the year	175	277
Released in the year	<u>(186)</u>	<u>(639)</u>
Outstanding at 31 December	<u><u>323</u></u>	<u><u>334</u></u>

The closing price of the HSBC Holdings plc share at 31 December 2013 was £6.62 (2012: £6.47).

The weighted average remaining vesting period as at 31 December 2013 was 1.25 years (2012: 0.51 years).

(e) Income statement charge

	2013	2012
Share awards plans	16	21
Share option plans	<u>33</u>	<u>49</u>
Income statement charge (note 13)	<u><u>49</u></u>	<u><u>70</u></u>
Equity-settled share-based payments *	49	70
Cash-settled share-based payments	<u>-</u>	<u>-</u>
	<u><u>49</u></u>	<u><u>70</u></u>

* This charge, which was computed from the fair values of the share-based payment transaction when contracted, arose under employee share awards made in accordance with the Group's reward structures.

57 Material related-party transactions

(a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates

In 2013, 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 life insurance 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.

NOTES TO THE FINANCIAL STATEMENTS (continued)

57 Material related-party transactions (continued)

(a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates (continued)

There was an arrangement whereby a fellow subsidiary provided certain management services, being services related to risk management, insurance business services, development and pricing for selected products, information technology and business recovery, financial operations and control, actuarial services and investment, to Hang Seng Insurance Company Limited. The 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	
	2013	2012	2013	2012 (restated)	2013	2012
Interest income	106	48	-	-	119	106
Interest expense	(375)	(303)	-	-	(3)	(4)
Other operating income	117	138	-	(2)	-	4
Operating expenses*	(738)	(784)	(550)	(433)	(29)	(22)
Amounts due from:						
Cash and balances with banks	1,960	834	458	247	-	-
Placings with and advances to banks	15,331	13,527	-	767	5,597	9,244
Financial assets designated at fair value	-	-	-	3,446	-	-
Derivative financial instruments	503	403	104	12	-	-
Loans and advances to customers	-	400	-	-	233	233
Financial investments	-	74	-	-	-	-
Other assets	23	19	-	41	7	4
	17,817	15,257	562	4,513	5,837	9,481
Amounts due to:						
Current, savings and other deposit accounts	1,042	871	-	-	112	110
Deposits from banks	1,051	4,960	66	44	166	1,213
Derivative financial instruments	802	536	54	121	-	-
Subordinated liabilities	11,824	11,821	-	-	-	-
Other liabilities	370	378	90	79	-	-
	15,089	18,566	210	244	278	1,323
Derivative contracts:						
Contract amount	85,784	91,252	73,713	52,041	-	-
Guarantees:						
Guarantees issued	-	-	-	-	-	116
Committed facilities:						
Committed facilities from	-	-	-	-	-	-
Committed facilities to	-	-	-	-	-	-

* 2013 Operating expenses included payment of HK\$88 million (2012: HK\$44 million) of software costs which were capitalised as intangible assets in the balance sheet of the Group.

NOTES TO THE FINANCIAL STATEMENTS (continued)

57 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	
	2013	2012	2013	2012 (restated)	2013	2012	2013	2012
Amounts due from:								
Cash and balances with banks	1,821	795	206	229	-	-	-	-
Placings with and advances to banks	15,308	13,504	-	767	-	-	4,690	6,899
Financial assets designated at fair value	-	-	-	-	-	-	-	-
Derivative financial instruments	437	335	104	13	153	75	-	-
Loans and advances to customers	-	400	-	-	-	-	-	-
Amounts due from subsidiaries	-	-	-	-	23,553	81,143	-	-
Financial investments	-	-	-	-	-	-	-	-
Other assets	18	15	-	41	-	-	7	4
	17,584	15,049	310	1,050	23,706	81,218	4,697	6,903
Amounts due to:								
Current, savings and other deposit accounts	1,039	840	-	-	-	-	102	78
Deposits from banks	409	2,899	66	44	-	-	166	92
Derivative financial instruments	629	250	53	120	175	345	-	-
Subordinated liabilities	11,824	11,821	-	-	-	-	-	-
Amounts due to subsidiaries	-	-	-	-	14,326	15,282	-	-
Other liabilities	247	278	78	79	-	-	-	-
	14,148	16,088	197	243	14,501	15,627	268	170
Derivative contracts:								
Contract amount	69,949	66,582	73,713	52,001	19,179	15,696	-	-
Guarantees:								
Guarantees issued	-	-	-	-	464	422	-	116
Guarantees received	-	-	-	-	-	22	-	-
Committed facilities:								
Committed facilities from	-	-	-	-	-	-	-	-
Committed facilities to	-	-	-	-	5,481	5,480	-	-

NOTES TO THE FINANCIAL STATEMENTS (continued)

57 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 15 and highest paid employees as disclosed in note 14, is as follows:

	Group		Bank	
	2013	2012	2013	2012
Salaries, allowances and benefits in kind	39	35	39	35
Retirement scheme contributions	4	4	4	4
Variable bonuses	33	30	33	30
	76	69	76	69

(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	
	2013	2012	2013	2012
For the year				
Interest income	287	239	287	239
Interest expense	7	9	7	9
Fees and commission income	13	34	13	34
Maximum aggregate amount of loans and advances	10,082	10,661	9,075	9,626
At the year-end				
Loans and advances	9,112	8,594	8,185	7,892
Deposits	3,586	2,349	3,091	2,091
Guarantees issued	27	83	27	83
Undrawn commitments	845	1,516	845	1,323

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 are no specific impairment allowances on balances with key management personnel at the year-end.

NOTES TO THE FINANCIAL STATEMENTS (*continued*)

57 Material related-party transactions (*continued*)

(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		
	2013	2012	2013	2012
Aggregate amount of relevant transactions outstanding at 31 December	<u>18</u>	<u>19</u>	<u>18</u>	<u>19</u>
Maximum aggregate amount of relevant transactions during the year	<u>22</u>	<u>24</u>	<u>22</u>	<u>24</u>

(e) Associates

Information relating to associates and transactions with associates can be found in notes 35 and 57(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 2013 was HK\$233 million (2012: HK\$233 million).

(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 56, 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 2013 amounted to HK\$648 million comprising HK\$653 million relating to share option schemes and negative reserve amounted to HK\$5 million relating to share award schemes (2012: HK\$618 million comprising HK\$625 million relating to share option schemes and negative reserve amounted to HK\$7 million relating to share award schemes).

(g) Employee retirement benefits

At 31 December 2013, defined benefit scheme assets amounted to HK\$1,873 million (2012: HK\$1,059 million) was under management by the Bank's subsidiary company and the related fee paid was HK\$6 million (2012: HK\$5 million).

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments

(a) Fair value of financial instruments carried at fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following tables set out the financial instruments carried at fair value.

	Group					
	Valuation techniques			Third party total	Amounts with HSBC entities *	Total
	Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3			
Recurring fair value measurements						
2013						
Assets						
Trading assets	22,146	9,850	-	31,996	-	31,996
Financial assets designated at fair value	4,531	1,956	500	6,987	-	6,987
Derivative financial instruments	414	5,622	3	6,039	607	6,646
Available-for-sale financial investments	125,701	84,655	984	211,340	-	211,340
Liabilities						
Trading liabilities	24,475	37,534	108	62,117	-	62,117
Financial liabilities designated at fair value	-	489	-	489	-	489
Derivative financial instruments	48	4,342	-	4,390	856	5,246
2012						
Assets						
Trading assets	30,930	3,469	-	34,399	-	34,399
Financial assets designated at fair value	2,545	1,874	478	4,897	3,446	8,343
Derivative financial instruments	325	4,278	161	4,764	415	5,179
Available-for-sale financial investments	112,245	73,308	224	185,777	-	185,777
Liabilities						
Trading liabilities	21,492	38,226	135	59,853	-	59,853
Financial liabilities designated at fair value	-	464	-	464	-	464
Derivative financial instruments	63	3,398	-	3,461	657	4,118
Bank						
	Valuation techniques					
	Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Third party total	Amounts with HSBC entities *	Total
Recurring fair value measurements						
2013						
Assets						
Trading assets	22,146	8,331	-	30,477	-	30,477
Financial assets designated at fair value	-	-	-	-	-	-
Derivative financial instruments	413	4,727	3	5,143	694	5,837
Available-for-sale financial investments	125,634	69,075	815	195,524	-	195,524
Liabilities						
Trading liabilities	24,475	5,352	87	29,914	-	29,914
Financial liabilities designated at fair value	-	-	-	-	-	-
Derivative financial instruments	42	3,587	-	3,629	857	4,486
2012						
Assets						
Trading assets	30,930	705	-	31,635	-	31,635
Financial assets designated at fair value	-	-	-	-	-	-
Derivative financial instruments	320	3,891	-	4,211	423	4,634
Available-for-sale financial investments	112,179	33,135	100	145,414	-	145,414
Liabilities						
Trading liabilities	21,492	6,167	117	27,776	-	27,776
Financial liabilities designated at fair value	-	-	-	-	-	-
Derivative financial instruments	57	2,745	-	2,802	715	3,517

* Included structured instruments and derivative contracts transacted with HSBC entities which were mainly classified within Level 2 of the valuation hierarchy.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

There were no material transfers between Level 1 and Level 2 during the year.

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined or validated by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the Group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia*:

- the extent to which prices may be expected to represent genuine traded or tradeable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

For fair values determined using a valuation model, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

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 compliance with all relevant accounting standards.

Determination of fair value

Fair values are determined according to the following hierarchy:

(i) Level 1: Quoted market price

Financial instruments with quoted prices for identical instruments in active markets that the Group can assess at the measurement date.

(ii) Level 2: Valuation technique using observable inputs

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

(iii) Level 3: Valuation technique with significant unobservable inputs

Financial instruments valued using models where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations. A range of valuation techniques is employed, dependent upon the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analysis, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to consideration of credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. Projection utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products are dependent upon more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may impact the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates.

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgmental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit ("day 1 gain or loss") or greater than 5% of the instrument's carrying value is driven by unobservable inputs. "Unobservable" in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). All fair value adjustments are included within the levelling determination.

The types of financial instruments carried at fair values are as follows:

- 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 unquoted equities, valuation techniques using inputs derived from observable and unobservable market data.

- Structured notes

The fair value of structured notes valued using a valuation technique is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative is determined as described in the paragraph below on derivatives.

Trading liabilities valued using a valuation technique with significant unobservable inputs principally comprised equity-linked structured notes, which are issued by the Group and provide the counterparty with a return that is linked to the performance of certain equity securities, and other portfolios. The notes are classified as level 3 due to the unobservability of parameters such as long-dated equity volatilities and correlations between equity prices, between equity prices and interest rates and between interest rates and foreign exchange rates.

- Derivatives

OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon "no-arbitrage" principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some discrepancies in practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures. Finally, some inputs are not observable, but can generally be estimated from historical data or other sources.

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, such as foreign exchange rates, interest rates and equity prices.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Fair value adjustments

Fair value adjustments are adopted when the Group considers that there are additional factors that would be considered by a market participant that are not incorporated within the valuation model. The Group classifies fair value adjustments as either 'risk-related' or 'model-related'. The majority of these adjustments relate to Treasury.

Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.

The major fair value adjustment categories being regularly reviewed by the Group are as follow:

Risk-related adjustments

- Bid-offer

HKFRS 13 requires use of the price within the bid-offer spread that is most representative of fair value. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the extent to which bid-offer cost would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the position.

- Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, there exists a range of possible values that the financial instrument or market parameter may assume and an adjustment may be necessary to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

- Credit valuation adjustment

The credit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the counterparty may default and that the Group may not receive the full market value of the transactions.

- Debit valuation adjustment

The debit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the Group may default, and that the Group may not pay full market value of the transactions.

Model-related adjustments

- Model limitation

Models used for portfolio valuation purposes may be based upon a simplifying set of assumptions that do not capture all material market characteristics. Additionally, markets evolve, and models that were adequate in the past may require development to capture all material market characteristics in current market conditions. In these circumstances, model limitation adjustments are adopted. As model development progresses, model limitations are addressed within the valuation models and a model limitation adjustment is no longer needed.

- Inception profit (Day 1 P&L reserves)

Inception profit adjustments are adopted where the fair value estimated by a valuation model is based on one or more significant unobservable inputs.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Financial instruments measured at fair value using a valuation technique with significant unobservable inputs - Level 3

	Group					
	Assets			Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss
2013						
Private equity	984	-	500	-	-	-
Structured notes	-	-	-	-	108	-
Derivatives	-	-	-	3	-	-
	984	-	500	3	108	-
2012						
Private equity	224	-	478	-	-	-
Structured notes	-	-	-	-	135	-
Derivatives	-	-	-	161	-	-
	224	-	478	161	135	-
Bank						
	Assets			Liabilities		
	Designated at fair value through profit or loss			Designated at fair value through profit or loss		
	Available-for-sale	Held for trading	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
2013						
Private equity	815	-	-	-	-	-
Structured notes	-	-	-	-	87	-
Derivatives	-	-	-	3	-	-
	815	-	-	3	87	-
2012						
Private equity	100	-	-	-	-	-
Structured notes	-	-	-	-	117	-
Derivatives	-	-	-	-	-	-
	100	-	-	-	117	-

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Movement in Level 3 financial instruments

	Group				Liabilities		
	Assets		Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
	Available-for-sale	Held for trading					
At 1 January 2013	224	-	478	161	135	-	-
Total gains or losses recognised in profit or loss							
- trading income					(81)	-	-
- net income from other financial instruments designated at fair value				27	-	-	-
- gains less losses from financial investments				-	-	-	-
Total gains or losses recognised in other comprehensive income							
- fair value gains/(losses)	148	-	-	-	-	-	-
- exchange differences	-	-	-	-	-	-	-
Purchases	-	-	92	-	-	-	-
Issues/ deposit taking	-	-	-	-	87	-	-
Sales	-	-	(10)	-	-	-	-
Settlements	-	-	(37)	(60)	(114)	-	-
Transfers out	-	-	(54)	(17)	-	-	-
Transfers in	612	-	4	-	-	-	-
At 31 December 2013	<u>984</u>	<u>-</u>	<u>500</u>	<u>3</u>	<u>108</u>	<u>-</u>	<u>-</u>

Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period							
- trading income					3	-	-
- net income from other financial instruments designated at fair value			25	-	-	-	-

	Group				Liabilities		
	Assets		Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
	Available-for-sale	Held for trading					
At 1 January 2012	150	-	634	71	523	-	-
Total gains or losses recognised in profit or loss	-	-	22	90	6	-	-
Total gains or losses recognised in other comprehensive income	74	-	-	-	-	-	-
Purchases	-	-	158	-	-	-	-
Issues/ deposit taking	-	-	-	-	415	-	-
Sales	-	-	(205)	-	-	-	-
Settlements	-	-	(86)	-	(653)	-	-
Transfers out	-	-	(45)	-	(156)	-	-
Transfers in	-	-	-	-	-	-	-
Exchange adjustments	-	-	-	-	-	-	-
At 31 December 2012	<u>224</u>	<u>-</u>	<u>478</u>	<u>161</u>	<u>135</u>	<u>-</u>	<u>-</u>
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	14	-	20	90	-	-	-

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Movement in Level 3 financial instruments (continued)

	Bank				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2013	100	-	-	-	-	117	-
Total gains or losses recognised in profit or loss					3	-	-
- trading income						-	-
- net income from other financial instruments designated at fair value						-	-
- gains less losses from financial investments						-	-
Total gains or losses recognised in other comprehensive income						-	-
- fair value gains/(losses)	103	-	-	-	-	-	-
- exchange differences	-	-	-	-	-	-	-
Purchases	-	-	-	-	-	-	-
Issues/ deposit taking	-	-	-	-	87	-	-
Sales	-	-	-	-	-	-	-
Settlements	-	-	-	-	(117)	-	-
Transfers out	-	-	-	-	-	-	-
Transfers in	612	-	-	-	-	-	-
At 31 December 2013	<u>815</u>	<u>-</u>	<u>-</u>	<u>3</u>	<u>87</u>	<u>-</u>	<u>-</u>

Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	
- trading income	
- net income from other financial instruments designated at fair value	
	3
	-

	Bank				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2012	44	-	-	-	-	421	-
Total gains or losses recognised in profit or loss	-	-	-	-	-	-	-
Total gains or losses recognised in other comprehensive income	56	-	-	-	-	-	-
Purchases	-	-	-	-	-	-	-
Issues/ deposit taking	-	-	-	-	338	-	-
Sales	-	-	-	-	-	-	-
Settlements	-	-	-	-	(642)	-	-
Transfers out	-	-	-	-	-	-	-
Transfers in	-	-	-	-	-	-	-
Exchange adjustments	-	-	-	-	-	-	-
At 31 December 2012	<u>100</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>117</u>	<u>-</u>	<u>-</u>

Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	
	7

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Movement in Level 3 financial instruments (continued)

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

Transfer in of Level 3 available-for-sale assets was due to reclassification of Yantai Bank from an associate to financial investment. For derivative assets, the transfer out of Level 3 reflects the change in observability of equity volatilities during the year. In respect of financial assets designated at fair value, the transfer out of Level 3 was due to change in portfolio mix of private equity investments.

Effect of changes in significant unobservable assumptions to reasonably possible alternatives

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions which are not evidenced 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 these fair values to reasonably possible alternative assumptions:

Sensitivity of fair values to reasonably possible alternative assumptions

	Group			
	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
2013				
Private equity	50	(50)	91	(91)
Structured notes	-	-	-	-
Derivatives	-	-	-	-
	50	(50)	91	(91)
2012				
Private equity	48	(48)	22	(22)
Structured notes	-	-	-	-
Derivatives	3	(3)	-	-
	51	(51)	22	(22)
Bank				
Reflected in profit or loss				Reflected in other comprehensive income
Favourable changes		Unfavourable changes		
2013				
Private equity	-	-	74	(74)
Structured notes	-	-	-	-
Derivatives	-	-	-	-
	-	-	74	(74)
2012				
Private equity	-	-	10	(10)
Structured notes	-	-	-	-
Derivatives	-	-	-	-
	-	-	10	(10)

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or the most unfavourable change from varying the assumptions individually.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Quantitative information about significant unobservable inputs in Level 3 valuations

		Group		Range
	Fair value at 31 December 2013	Valuation technique(s)	Unobservable input(s)	
Assets				
Private equity	1,484	Net asset value Market-comparable approach	N/A Earnings Multiple Liquidity Discount	N/A 20 - 33 10% - 30%
Derivatives	3	Option model	Equity Volatility FX Volatility	7.21% - 72.54% 1.85% - 7.68%
Liabilities				
Structured notes	108	Option model	FX Volatility Equity and Equity Index Correlation	6.15% - 11.65% 0.508 - 0.588
 Bank				
	Fair value at 31 December 2013	Valuation technique(s)	Unobservable input(s)	Range
Assets				
Private equity	815	Net asset value Market-comparable approach	N/A Earnings Multiple Liquidity Discount	N/A 20 - 33 10% - 30%
Derivatives	3	Option model	Equity Volatility FX Volatility	7.21% - 72.54% 1.85% - 7.68%
Liabilities				
Structured notes	87	Option model	FX Volatility	6.15% - 11.65%

Key unobservable inputs to Level 3 financial instruments

The table above lists the key unobservable inputs to Level 3 financial instruments, and provides the range of those inputs as at 31 December 2013. A further description of the categories of key unobservable inputs is given below.

Private equity

The Group's private equity includes investment funds and unlisted equity shares, which are classified as designated at fair value through profit or loss or available-for-sale and are not traded in active markets. In the absence of an active market, the investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership.

Investment funds are valued using their net asset value. Higher net asset value results in higher fair value, and vice versa. Given the bespoke nature of the analysis, it is not practical to quote a range of key observable inputs.

For unlisted available-for-sale equity shares, the fair values are determined with reference to multiples of comparable listed companies, such as price/earning ratio of comparables, adjusted for a liquidity discount to reflect the fact that the shares are not actively traded. An increase in the ratio in isolation will result in favourable movement in the fair values, while an increase in liquidity discount in isolation will result in unfavourable movement.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(a) Fair value of financial instruments carried at fair value (continued)

Key unobservable inputs to Level 3 financial instruments (continued)

Volatility

Volatility is a measure of the anticipated future variability of a market price. Volatility tends to increase in stressed market conditions, and decrease in calmer market conditions. Volatility is an important input in the pricing of options. In general, the higher the volatility, the more expensive the option will be. This reflects both the higher probability of an increased return from the option, and the potentially higher costs that the Group may incur in hedging the risks associated with the option. If option prices become more expensive, this will increase the value of the Group's long option positions (i.e. the positions in which the Group has purchased options), while the Group's short option positions (i.e. the positions in which the Group has sold options) will suffer losses.

Volatility varies by underlying reference market price, and by strike and maturity of the option. Volatility also varies over time. As a result, it is difficult to make general statements regarding volatility levels.

Certain volatilities, typically those of a longer-dated nature, are unobservable. The unobservable volatility is then estimated from observable data.

The range of unobservable volatilities quoted in the table reflects the wide variation in volatility inputs by reference market price. For any single unobservable volatility, the uncertainty in the volatility determination is significantly less than the range quoted above.

Correlation

Correlation is a measure of the inter-relationship between two market prices. Correlation is a number between minus one and one. A positive correlation implies that the two market prices tend to move in the same direction, with a correlation of one implying that they always move in the same direction. A negative correlation implies that the two market prices tend to move in opposite directions, with a correlation of minus one implying that the two market prices always move in opposite directions.

Correlation is used to value more complex instruments where the payout is dependent upon more than one market price. Correlation may be unobservable. Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, the Group's trade prices, proxy correlations and examination of historical price relationships.

The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair. For any single unobservable correlation, the uncertainty in the correlation determination is likely to be less than the range quoted above.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(b) Fair value of financial instruments not carried at fair value

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

	Carrying amount	Group			Fair value	2012	
		2013		With significant unobservable inputs Level 3		2012	
		Quoted market price Level 1	Using observable inputs Level 2			Carrying amount	Fair value
Financial Assets							
Placings with and advances to banks	131,363	-	131,330	-	131,330	140,382	140,535
Loans and advances to customers	586,240	-	1,400	581,493	582,893	536,162	532,884
Held-to-maturity debt securities	71,505	427	71,546	41	72,014	67,631	72,716
Financial Liabilities							
Current, savings and other deposit accounts	824,996	-	825,093	-	825,093	769,147	769,223
Deposits from banks	11,826	-	11,826	-	11,826	19,845	19,845
Certificates of deposit and other debt securities in issue	8,601	-	8,601	-	8,601	11,291	11,317
Subordinated liabilities	11,824	-	13,799	-	13,799	11,821	14,107
Bank							
	Carrying amount	2013			Fair value	2012	
		Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3		2012	
						Carrying amount	Fair value
Financial Assets							
Placings with and advances to banks	96,788	-	96,788	-	96,788	74,846	74,846
Loans and advances to customers	519,135	-	1,281	514,507	515,788	476,734	473,451
Financial Liabilities							
Current, savings and other deposit accounts	774,462	-	774,560	-	774,560	730,533	730,609
Deposits from banks	10,012	-	10,012	-	10,012	13,952	13,952
Certificates of deposit and other debt securities in issue	8,601	-	8,601	-	8,601	11,291	11,317
Subordinated liabilities	11,824	-	13,799	-	13,799	11,821	14,107

The calculation of fair values of financial instruments that are not carried at fair value is described below.

The calculation of fair value incorporates the Group's estimate of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 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.

(i) Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. These assumptions may include value estimates from third party brokers which reflect over-the-counter trading activity; forward looking discounted cash flow models using assumptions which the Group believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors, including vintage, origination period, estimates of future interest rates, prepayment speeds, delinquency rates, loan-to-value ratios, the quality of collateral, default probability, and internal credit risk ratings.

Valuation techniques are calibrated on a regular basis and tested for validity using prices from observable current market transactions in the same instrument, without modification or repackaging, or are based on any available observable market data.

The fair value of a loan reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans, and the fair value impact of repricing between origination and the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

NOTES TO THE FINANCIAL STATEMENTS (continued)

58 Fair value of financial instruments (continued)

(b) Fair value of financial instruments not carried at fair value (continued)

(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 the prices and future earnings streams of equivalent quoted securities.

(iii) Deposits by banks and customer accounts

For the purpose of estimating fair value, deposits by banks and customer accounts are grouped by remaining contractual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit 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.

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

Assets

Cash and balances at central banks
Items in the course of collection from other banks
Acceptances and Endorsements
Short-term receivables within "Other assets"
Accrued income

Liabilities

Items in the course of transmission to other banks
Acceptances and Endorsements
Short-term payables within "Other liabilities"
Accruals

NOTES TO THE FINANCIAL STATEMENTS (continued)

59 Comparative figures

As a result of the adoption of the amendments to HKAS 19 "Employee Benefits", certain comparative figures have been adjusted to conform with the current year's presentation and to provide comparative amounts in respect of items disclosed for the first time in 2013.

60 Immediate and ultimate holding companies

The immediate and ultimate holding companies of the Bank are The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong) and HSBC Holdings plc (incorporated in England) respectively.

61 Change in accounting treatment for Industrial Bank Co., Ltd. ("Industrial Bank") and Yantai Bank Co., Ltd ("Yantai Bank")

Industrial Bank

On 7 January 2013, Industrial Bank completed a private placement of additional share capital to a number of third parties, thereby diluting the Group's equity holding from 12.8% to 10.9%. As a result of this and other factors, the Group considers that it is no longer in a position to exercise significant influence over Industrial Bank and it therefore ceased to account for the investment as an associate (note 35) from that date, giving rise to an accounting gain on reclassification of Industrial Bank of HK\$9,517 million in 2013. The accounting gain included the deemed disposal profit on the reclassification of HK\$8,454 million and the release of deferred tax amounted to HK\$1,063 million.

The holding in Industrial Bank has since been recognised as a financial investment (note 32) in the balance sheet of the Group, with any subsequent movement in its fair value reflected in accordance with current applicable Hong Kong Financial Reporting Standards. At 31 December 2013, there was a revaluation deficit on the investment in Industrial Bank recorded in the "available-for-sale investment reserve", reflecting the decline in its fair value below the deemed cost upon reclassification based on the share price on 4 January 2013. The change in fair value of the Bank's investment in Industrial Bank is recognised in the available-for-sale investment reserve unless the investment becomes impaired. If the investment becomes impaired, the cumulative revaluation deficit would be reclassified from the available-for-sale investment reserve to the income statement.

The Group will continue to perform an impairment review of its investment in Industrial Bank at each balance sheet date in accordance with the Group's accounting policy on impairment of available-for-sale financial assets. Dividends from Industrial Bank are recognised in the Group's consolidated income statement. This change has been incorporated and reflected in the Group's 2013 annual results.

NOTES TO THE FINANCIAL STATEMENTS (continued)

61 Change in accounting treatment for Industrial Bank Co., Ltd. ("Industrial Bank") and Yantai Bank Co., Ltd ("Yantai Bank") (continued)

Industrial Bank (continued)

Financial implication of change in accounting treatment on Industrial Bank:

From 2013 onwards, the reclassification of Industrial Bank and the change in accounting treatment will result in an increase in the Group's dividend income, subject to the amount of dividend to be declared by Industrial Bank and a decrease in the share of profit from associates. The share of profit from Industrial Bank was HK\$5,199 million in 2012.

Since there are significant financial implications as a result of the change in accounting treatment for Industrial Bank, the key financial results and performance metrics are not directly comparable when comparing 2013 with 2012. For the sake of comparison, we have prepared the following key financial results and performance metric by excluding the accounting gain in 2013 and share of Industrial Bank's profit in 2012.

	As reported			Excluding Industrial Bank reclassification		
	Year ended 31 December 2013	Year ended 31 December 2012	Change	Year ended 31 December 2013	Year ended 31 December 2012	Change
	Attributable profit 26,678	19,327	38.0%	17,161	14,472	18.6%
Profit before tax	28,496	21,994	29.6%	20,042	16,795	19.3%
Earnings per share (HK\$)	13.95	10.11	38.0%	8.98	7.57	18.6%

Yantai Bank

The Group's investment in Yantai Bank was equity accounted with effect from January 2009, reflecting the Group's significant influence over this associate. On 13 December 2013, Yantai Bank approved an increase in its registered share capital to enable a private placement of additional share capital to a third party, leading to the Group's equity holding being diluted from 20% to 15.09%. As a result of this and other factors, the Group considers that it is no longer in a position to exercise significant influence over Yantai Bank and ceased to account for its investment as an associate (note 35) from that date. Thereafter, the holding in Yantai Bank is classified as an available-for-sale financial investment (note 32). The loss arising from this reclassification was HK\$297 million and is reflected in the Group's 2013 financial statements. The change in accounting treatment did not have significant impact on the Group income statement for 2013.

62 Approval of financial statements

The financial statements were approved and authorised for issue by the Board of Directors on 24 February 2014.

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") and its subsidiaries (together "the Group") set out on pages 142 to 264, which comprise the consolidated and the Bank balance sheets as at 31 December 2013, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information.

Directors' responsibility for the consolidated financial statements

The directors of the Bank are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the consolidated financial statements that give a true and fair view 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 consolidated 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 2013 and of the Group's profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

KPMG
Certified Public Accountants

8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong

24 February 2014

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (*unaudited*)

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

These notes set out on pages 266 to 286 are supplementary to and should be read in conjunction with the consolidated financial statements set out on pages 142 to 264. The consolidated financial statements and these supplementary notes taken together comply with the Banking (Disclosure) Rules (the "Disclosure Rules") made under section 60A of the Banking Ordinance, as amended by the Banking (Disclosure) (Amendment) Rules 2013 which came into operation on 30 June 2013.

1 Basis of preparation

- (a) Except where indicated otherwise, the financial information contained in these supplementary notes has been prepared on a consolidated basis in accordance with Hong Kong Financial Reporting Standards. Some parts of these supplementary notes, however, are required by the Disclosure Rules to be prepared on a different basis. In such cases, the Disclosure Rules require that certain information is prepared on a basis which excludes 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 Management Discussion and Analysis.

- (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 2013 as set out in note 3 to the financial statements.
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SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

2 Credit risk capital requirements

The table below shows the capital requirements for credit risk for each class and subclass of exposures as specified in the Capital Rules.

	2013	2012
Subject to internal ratings-based approach		
Sovereign exposures	1,279	492
Bank exposures	2,510	2,061
Corporate exposures	17,403	16,096
Residential mortgages to individuals and property-holding shell companies	772	626
Qualifying revolving retail exposures	1,258	1,166
Small business retail exposures	14	16
Other retail exposures to individuals	359	349
Other exposures	1,784	1,418
Securitisation exposures	-	-
Equity exposures	1,381	-
Credit valuation adjustment	178	-
Total capital requirements for credit risk under internal ratings-based approach	26,938	22,224
Subject to standardised (credit risk) approach		
<i>On-balance sheet</i>		
Sovereign exposures	-	-
Public sector entity exposures	137	110
Multilateral development bank exposures	-	-
Bank exposures	10	-
Securities firm exposures	-	1
Corporate exposures	986	345
Collective investment scheme exposures	-	3
Cash items	-	-
Regulatory retail exposures	101	110
Residential mortgage loans	798	578
Other exposures which are not past due exposures	127	142
Past due exposures	24	25
Total capital requirements for on-balance sheet exposures	2,183	1,314
<i>Off-balance sheet</i>		
Direct credit substitutes	30	17
Transaction-related contingencies	1	-
Trade-related contingencies	3	3
Forward asset purchases	3	4
Partly paid-up shares and securities	-	-
Forward forward deposits placed	-	-
Unconditionally cancellable commitments	-	-
Other commitments	30	81
Exchange rate contracts	2	5
Interest rate contracts	3	1
Equity contracts	12	8
OTC derivative transactions and credit derivative contracts subject to valid bilateral netting agreements	1	2
Other off-balance exposures which are not elsewhere specified	-	-
Total capital requirements for off-balance sheet exposures	85	121
Total capital requirements for credit risk under standardised (credit risk) approach	2,268	1,435
Total capital requirements for credit risk	29,206	23,659

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)

3 Credit risk under the internal ratings-based approach

(a) The internal rating system

(i) Nature of exposures within each internal ratings-based ("IRB") class

The Group adopted advanced IRB approach for the majority of its business with effect from 1 January 2009. The following exposures are subject to IRB approach:

- Corporate exposures include exposures to global large corporates, local large corporates, middle market corporates and small and medium-sized enterprises, non-bank financial institutions and specialised lending.
- Sovereign exposures include exposures to central governments, government agencies, central monetary institutions and relevant international organisations.
- Bank exposures include exposures to banks and regulated securities firms.
- Retail exposures include residential mortgages, qualifying revolving retail exposures, small business retail exposures and other retail exposures to individuals.
- Other exposures mainly include notes and coins, premises, plant and equipment and other assets.

(ii) Risk rating systems and control mechanisms

The Group's exposure to credit risk arises from a wide range of customers and product types. To measure and manage the risk in these exposures, both to distinct customer types or product categories, the Group employs diverse risk rating systems and methodologies: judgmental, analytical, and hybrids of the two.

A fundamental principle of the Group's policy and approach is that analytical risk rating systems and scorecards are decision tools facilitating management, serving ultimately judgemental decisions for which individual approvers are accountable. In case of automated decision making process, accountability rests with those responsible for the parameters built into those processes/systems and the controls surrounding their use. For individually assessed customers, the credit process provides for at least annual review of the facility granted. Review may be more frequent, as required by circumstances.

The Group adopts a set of standards that govern the process through which risk rating systems are developed, judged fit for purpose, approved and implemented, the conditions under which analytical risk model outcomes can be overridden by approvers; and the process of model performance monitoring and reporting. The framework emphasises on an effective dialogue between business line and risk management, suitable independence of decision takers and a good understanding and robust challenge of senior management.

Analytical risk rating systems are not static and are subject to review and modification in light of the changing environment and the availability or quality of data. Processes are established to capture the relevant data for continuous model improvement.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(a) The internal rating system (continued)

(iii) Application of IRB parameters

The Group-wide credit risk rating framework incorporates probability of default ("PD", representing the likelihood of a default event in a one-year horizon) of an obligor and loss severity expressed in terms of exposures at default ("EAD", an estimate of exposures at time of default) and loss given default ("LGD", the estimates of loss that the Group may incur in the event of default expressed as a percentage of EAD). These measures are used to calculate expected loss and capital requirements. They are also used in conjunction with other inputs to form rating assessments for the purpose of credit approval and for risk management decisions.

For sovereign, bank and corporate exposures, PD models are developed based on historical loss data, combining financial statistics and expert inputs on various aspects such as industry environment, financial trend and quality assessment on the companies. PD model for sovereign exposures incorporates both quantitative and qualitative data on economic, political, financial and social conditions. For corporate, bank and sovereign exposures, obligor PD is estimated using a Customer Risk Rating (CRR) of 23 grades, of which 21 are non-default ratings representing varying degrees of strength of financial condition, and two are default ratings. Credit score generated by a model and/or a scorecard for individual obligor, mapped to the corresponding Customer Risk Rating, is recommended to and reviewed by credit approver taking into account all relevant information (including external rating and market data where available) for risk rating determination. The approved CRR is mapped to a PD value range of which the "mid-point" is used in regulatory capital calculation. PD models are developed where the risk profile of corporate borrower is specific to a country or a region.

LGD and EAD estimation for wholesale business is subject to Group framework of basic principles. EAD is estimated to a 12-month horizon and broadly represents the current exposure plus an estimate for future draw down on undrawn facilities and the crystallization of contingent exposures after default. LGD focuses on the facility and collateral structure which takes into account the priority/seniority of the facility, the type and value of the collateral and past experience on the type of counterparty, which is expressed as a percentage of EAD.

The Group uses supervisory slotting criteria approach in rating its regulatory specialised lending exposure. Under this approach, rating will be assigned based on the borrower and transaction characteristics.

For retail business including residential mortgage exposures, qualifying revolving retail exposures, small business retail exposures and other retail exposures to individuals, a wide range of application and behavioural models used in the management of retail portfolios has been supplemented to develop the credit models for measuring PD, EAD and LGD under the IRB approach. The PD models typically incorporate the characteristics of the products and the borrower's account behaviour.

EAD models are developed for retail revolving exposures to predict additional drawdown at the time of default, plus current outstanding balance. For non-revolving retail exposures such as residential mortgage, EAD is mainly estimated based on current outstanding balance.

LGD models for retail exposures are developed based on the Group's internal loss and default experience including recovery values for different types of collaterals for secured retail exposures such as residential mortgage; for unsecured retail exposures such as qualifying revolving retail exposures, LGD models are developed based on past recovery experiences, account behaviours and repayment ability.

For management information and reporting purposes, retail portfolios are segmented into 10 Expected Loss ("EL") bands facilitating comparability across retail customer segment and product types. EL band is derived through a combination of PD and LGD.

(iv) Model Governance

Model governance is under the general oversight of HSBC Group or Regional Model Oversight Committee ("Group MOC"). Local Model Oversight Committee ("Local MOC") is established for Wholesale Credit and Market Risk ("WCMR") and Retail Banking and Wealth Management ("RBWM") respectively in the Bank with comparable terms of reference as Group MOC. Local MOCs meet bi-monthly and report to Risk Management Committee. They are chaired by the Risk function, and its membership is drawn from Risk, Finance and global businesses.

Compliance with the Group standards for development, validation and implementation of credit risk models are subject to review by Independent Model Review Team and Internal Audit. Internal Audit also conducts regular reviews of the risk rating model application by business groups.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(a) The internal rating system (continued)

(v) Use of internal ratings

While internal estimates derived from applying the IRB approach are employed in the calculation of risk-weighted exposure amounts for the purpose of determining regulatory capital requirements, they are also used in a multitude of contexts within risk management and business processes. Such uses continue to develop and become embedded as experience grows and the repository of quality data improves. They include:

- credit approval: authorities, including those for specific counterparty types and transactions, are delegated to officers and executives in the Group's credit risk function and business division involving lending activities using a risk-based approach, tiered relative to obligor customer risk rating;
- credit risk analytical tools: IRB measures are valuable tools deployed in the assessment of customer and portfolio risk; migration of customer risk rating becomes an important indicator in credit monitoring process;
- pricing: customer relationship managers apply a risk adjusted return on capital methodology in risk-weighted assets and profitability calculators;
- portfolio management: regular reports to Risk Management Committee, Audit Committee containing analyses of risk exposures employing IRB risk metrics, e.g. by customer segment and credit quality grade;
- economic capital: IRB risk measures are essential components of the credit risk economic capital model, which are evaluated in the capital adequacy assessment process of the Group;
- stress testing: IRB risk measures are stressed to understand the sensitivities of the Group's capital and business plans under adverse economic environment; and
- risk appetite: IRB risk capital and risk estimates are elements of the risk appetite and internal risk control measures of the Group.

(vi) Credit risk mitigation

The Group's approach when granting credit facilities is on the basis of capacity to repay, rather than primarily rely on credit risk mitigation. Depending on a customer's standing and the type of product, facilities may be provided on unsecured basis. Nevertheless, mitigation of credit risk is an important aspect of effective management and takes in many forms.

The Group's general policy is to promote the use of credit risk mitigation, justified by commercial prudence and good practice as well as capital efficiency. Policies covering the acceptability, structuring, control and valuation with regard to different types of collateral security are established to ensure that they are supported by evidence and continue to fulfil their intended purpose.

The main types of recognised collateral taken by the Group are those as stated in section 80 of the Capital Rules, including (but not limited to) cash on deposit, gold bullion, equities listed in a main index and/or a recognised exchange, collective investment schemes, various recognised debt securities, residential, industrial and commercial property, etc.

The Group's policy provides that netting is only to be applied where it has the legal right to do so. Consistent with the Capital Rules, only bilateral netting arrangements are included for capital adequacy credit risk mitigation calculation.

In terms of the application within IRB approach, credit risk mitigants are considered in two broad categories: first, those which reduce the intrinsic probability of default of an obligor and therefore operate as adjustments to PD estimation, and second, those which affect estimated recoverability of obligations and require adjustment of LGD. The first includes, for example, full parental or group company guarantees; the second, collateral security of various kinds such as cash, equity, properties, fixed assets such as motor vehicles, plant and machinery, stock and debtors, bank and sovereign guarantees, etc.

(b) Exposures subject to supervisory estimates

The following table indicates the exposure classes and the respective exposure amounts that are subject to supervisory estimates as at 31 December:

	2013	2012
IRB Exposure Class		
Sovereign exposures	-	-
Bank exposures	-	-
Corporate exposures	<u>26,101</u>	<u>36,916</u>
Total EAD	<u><u>26,101</u></u>	<u><u>36,916</u></u>

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(c) Exposures by IRB calculation approach

The table below shows the Group's exposures:

	Advanced IRB approach	Supervisory slotting criteria approach	Retail IRB approach	Specific risk-weight approach	Total exposures
2013					
Sovereign exposures	157,251	-	-	-	157,251
Bank exposures	172,618	-	-	-	172,618
Corporate exposures	356,502	26,101	-	-	382,603
Retail exposures:					
- Residential mortgages to individuals and property-holding shell companies	-	-	155,100	-	155,100
- Qualifying revolving retail exposures	-	-	79,793	-	79,793
- Small business retail exposures	-	-	5,356	-	5,356
- Other retail exposures to individuals	-	-	9,920	-	9,920
Equity exposures	-	-	-	6,262	6,262
Other exposures	-	-	-	45,335	45,335
	686,371	26,101	250,169	51,597	1,014,238
2012					
Sovereign exposures	148,797	-	-	-	148,797
Bank exposures	185,175	-	-	-	185,175
Corporate exposures	321,125	36,916	-	-	358,041
Retail exposures:					
- Residential mortgages to individuals and property-holding shell companies	-	-	149,518	-	149,518
- Qualifying revolving retail exposures	-	-	74,855	-	74,855
- Small business retail exposures	-	-	5,526	-	5,526
- Other retail exposures to individuals	-	-	9,423	-	9,423
Other exposures	-	-	-	30,926	30,926
	655,097	36,916	239,322	30,926	962,261

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(d) Exposures by credit risk mitigation used

The table below shows the Group's exposures (after the effect of any on-balance sheet or off-balance sheet recognised netting) which are covered by recognised guarantees after the application of haircuts required under the Capital Rules. These exposures exclude OTC derivative transactions.

Portfolio	2013	2012
Bank exposures	4,278	3,696
Corporate exposures	155,841	104,359
Retail exposures	15,789	15,299
	175,908	123,354

For the class of sovereign exposures, there were no exposures covered by recognised guarantees.

(e) Risk assessment for exposures under IRB approach

The tables below detail the total EAD of sovereign, bank and corporate exposures by exposure-weighted average risk-weight, exposure-weighted average PD and exposure-weighted average LGD for each obligor grade as at 31 December.

(i) Sovereign, bank and corporate (other than specialised lending) exposures - analysis by obligor grade

The exposures at default disclosed below in respect of sovereign, bank and corporate exposures have taken into account the effect of recognised collateral and recognised guarantees.

	2013			
	Exposure-weighted average	Exposure-weighted average	Exposure-weighted average risk-weight	Exposure at default
	PD %	LGD %	%	
Sovereign exposure				
Minimal default risk	0.02	45.00	5.94	91,301
Low default risk	0.07	45.00	16.02	65,950 157,251
Bank exposure				
Minimal default risk	0.04	25.04	7.56	50,814
Low default risk	0.08	35.55	17.45	96,289
Satisfactory default risk	0.30	34.23	39.98	23,969
Fair default risk	0.98	34.93	66.36	1,409
Moderate default risk	2.98	42.46	130.52	72
Significant default risk	7.42	52.79	190.39	64
High default risk	10.00	81.82	338.97	1 172,618
Corporate exposure (other than specialised lending)				
Minimal default risk	0.04	41.34	13.21	16,663
Low default risk	0.11	43.42	28.29	100,620
Satisfactory default risk	0.41	41.51	54.85	137,813
Fair default risk	1.25	41.55	86.81	63,640
Moderate default risk	2.99	37.11	103.31	34,958
Significant default risk	6.93	37.51	141.29	1,590
High default risk	11.56	25.44	125.00	100
Special management	19.00	59.00	363.35	2
Default	100.00	50.46	-	1,116 356,502

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(e) Risk assessment for exposures under IRB approach (continued)

(i) Sovereign, bank and corporate (other than specialised lending) exposures - analysis by obligor grade (continued)

	2012			
	Exposure-weighted average PD %	Exposure-weighted average LGD %	Exposure-weighted average risk-weight %	Exposure at default
Sovereign exposure				
Minimal default risk	0.01	10.16	0.72	101,052
Low default risk	0.07	29.77	11.35	47,745
				<u><u>148,797</u></u>
Bank exposure				
Minimal default risk	0.04	24.08	5.18	49,391
Low default risk	0.08	35.71	13.46	114,819
Satisfactory default risk	0.35	33.85	33.08	18,275
Fair default risk	0.93	33.99	56.01	2,425
Moderate default risk	3.58	39.78	108.51	238
Significant default risk	6.35	80.44	274.19	14
High default risk	10.00	68.49	283.55	13
				<u><u>185,175</u></u>
Corporate exposure (other than specialised lending)				
Minimal default risk	0.04	39.59	14.60	31,041
Low default risk	0.11	43.86	26.88	94,257
Satisfactory default risk	0.39	44.76	55.26	106,378
Fair default risk	1.23	42.81	87.40	48,957
Moderate default risk	2.74	38.33	108.71	37,104
Significant default risk	6.75	47.29	171.77	1,561
High default risk	11.31	36.39	158.37	241
Special management	18.73	22.52	124.41	492
Default	100.00	53.17	-	1,094
				<u><u>321,125</u></u>

(ii) Corporate exposures (specialised lending) - analysis by supervisory rating grade

	2013		2012	
	Exposure-weighted average risk-weight %	Exposure at default	Exposure-weighted average risk-weight %	Exposure at default
Obligor Grade				
Strong	64.97	23,783	66.98	32,694
Good	88.83	2,222	84.49	3,467
Satisfactory	121.90	96	121.90	755
Weak	-	-	-	-
		<u><u>26,101</u></u>		<u><u>36,916</u></u>

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(e) Risk assessment for exposures under IRB approach (continued)

(iii) Retail exposures - analysis by credit quality

The table below shows a breakdown of exposures (the EAD of on-balance sheet exposures and off-balance sheet exposures) on a pool basis by credit quality classification:

	Residential mortgages	Qualifying revolving retail exposures	Small business retail exposures	Other retail exposures	Total exposures
2013					
Strong	154,534	68,938	5,101	7,265	235,838
Medium	456	10,554	167	2,555	13,732
Sub-standard	-	292	-	80	372
Impaired	110	9	88	20	227
	155,100	79,793	5,356	9,920	250,169
2012					
Strong	148,865	64,578	5,460	6,992	225,895
Medium	534	10,085	51	2,333	13,003
Sub-standard	-	185	-	77	262
Impaired	119	7	15	21	162
	149,518	74,855	5,526	9,423	239,322

(iv) Undrawn commitments

The table below shows the amount of undrawn commitments and exposure-weighted average EAD for sovereign, bank and corporate exposures as at 31 December:

	2013			
	Undrawn commitments	Exposure-weighted average EAD	Undrawn commitments	Exposure-weighted average EAD
Sovereign exposures	-	-	-	-
Bank exposures	288	123	590	269
Corporate exposures	127,793	34,625	135,416	43,391
	128,081	34,748	136,006	43,660

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(f) Analysis of actual loss and estimates

The table below shows the actual losses which represent the net charges (including write-offs and impairment loss allowances) made during the year.

Exposure Class	2013	2012
Sovereign	-	-
Bank	-	-
Corporate	55	243
Residential mortgage	(20)	(28)
Qualifying revolving retail	456	367
Other retail	108	72
	599	654

The actual losses in 2013 decreased mainly due to fewer corporate loans written off.

The table below shows the expected loss which is the estimated future loss over a one-year time horizon for different exposure classes under IRB approach.

Exposure Class	31 December 2012	31 December 2011
Sovereign	11	14
Bank	71	58
Corporate	1,672	1,869
Residential mortgage	78	77
Qualifying revolving retail	476	430
Other retail	172	130
	2,480	2,578

Overall estimated expected losses in 2013 remained stable compared to 2012.

It should be noted that actual loss and expected loss are measured and calculated using different methodologies which may not be directly comparable. The limitation arises mainly from the fundamental differences in the definition of "loss" under expected loss calculation which is derived based on regulatory rules and actual loss includes write-offs and impairment loss allowances.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(f) Analysis of actual loss and estimates (continued)

The tables below set out the comparison of the predicted risk estimates of the Group's credit risk models against actual outcomes of the wholesale and retail exposures.

(i) Wholesale exposures

Risk estimates as at 31 December 2012 against actual outcome for the year 2013

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Sovereign exposure	-	0.07	-	16.45	-	100.00
Bank exposure	-	0.36	-	30.38	-	98.79
Corporate exposure	0.28	1.31	29.72	44.62	69.74	79.28

Risk estimates as at 31 December 2011 against actual outcome for the year 2012

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Sovereign exposure	-	0.05	-	23.59	-	100.00
Bank exposure	-	0.40	-	30.16	-	98.68
Corporate exposure	0.21	1.47	34.70	43.56	38.14	76.51

The actual PD rate is measured by using the number of obligor defaulted during the reporting period whereas the estimated PD rate is the long run average default rate estimated at the beginning of the reporting period. The PD estimated by internal model is calibrated to the Group's long run default experience. Hence, actual default rate in a particular year ("point-in-time") will typically differ from the estimated PD which is the "through the cycle" estimates as economies move above or below cyclical norms.

The estimated LGD is the exposure weighted average LGD for the portfolio, adjusted by a downturn factor, as of the beginning of the reporting period whereas the actual LGD is computed using the resolved default cases accumulated in 2013 which covers cases defaulted in or before 2013. No default and loss has been observed for Bank and Sovereign exposures during the reporting period.

The estimated EAD% represents the ratio of total model estimated exposure values to total limits for the portfolio at the beginning of the reporting period. The actual EAD% compares the realised EAD of the resolved default cases accumulated in 2013 which covers cases defaulted in or before 2013 to the limits 1 year prior to default.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

3 Credit risk under the internal ratings-based approach (continued)

(f) Analysis of actual loss and estimates (continued)

(ii) Retail exposures

Risk estimates as at 31 December 2012 against actual outcome for the year 2013

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Residential mortgages to individuals and property-holding shell companies	0.11	0.50	0.68	10.89	94.43	100.00
Qualifying revolving retail exposures	0.36	0.53	86.38	93.94	85.75	93.34
Small business retail exposures	0.32	0.61	1.31	10.07	93.77	100.00
Other retail exposures to individuals	2.28	2.57	60.53	76.18	78.58	98.24

Remarks: The portfolio which was newly approved to use internal ratings-based approach in 2011 is excluded in the above LGD analysis.

Risk estimates as at 31 December 2011 against actual outcome for the year 2012

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Residential mortgages to individuals and property-holding shell companies	0.17	0.50	0.79	10.61	93.13	100.00
Qualifying revolving retail exposures	0.32	0.53	84.73	91.61	87.67	93.43
Small business retail exposures	0.05	0.66	1.13	8.13	97.86	100.00
Other retail exposures to individuals	2.27	2.35	68.33	87.57	77.18	99.03

The actual and estimated PD rate are measured in the same ways as wholesale exposure.

The actual LGD for the retail exposures takes into account the 24-months recovery period and represents the realised LGD for cases defaulted during 2011 which were recovered within 24 months after default. The estimated LGD is the exposure weighted average LGD for the defaulted cases estimated prior to default.

The estimated EAD% represents the ratio of total model estimated EAD to total limits for cases defaulted during 2013 whereas the actual EAD% compares the exposure values of the cases defaulted in 2013 at the time of default against the maximum limit 1 year prior to default.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

4 Credit risk under the standardised (credit risk) approach

(a) Ratings from External Credit Assessment Institutions ("ECAIs")

The Group uses the following ECAIs to calculate its capital adequacy requirements under the standardised (credit risk) approach prescribed in the Capital Rules:

- Fitch Ratings
- Moody's Investors Service
- Standard & Poor's Ratings Services, and

Where exposures have been rated by the above-mentioned ECAIs, they are categorised under the following class of exposures:

- Sovereign exposures
- Public sector entity exposures
- Multilateral development bank exposures
- Bank exposures
- Securities firm exposures
- Corporate exposures
- Collective investment scheme exposures

The process used to map ECAIs issuer ratings or ECAIs issue specific ratings in the Group's banking book is consistent with those prescribed in the Capital Rules.

(b) Credit risk mitigation

As stated in sections 98 and 99 of the Capital Rules, certain guarantees and credit derivative contracts are recognised for credit risk mitigation purposes. The main types of guarantees are from sovereigns, corporate and banks. With corporate guarantees, in order for it to be recognised as a credit risk mitigants, it must have a credit rating of A- or better by Standard & Poor's Ratings Services, Fitch Ratings or a credit rating of A3 or better by Moody's Investors Service.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

4 Credit risk under the standardised (credit risk) approach (continued)

(c) Credit risk exposures under the standardised (credit risk) approach

2013

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 guarantees or recognised credit derivative contracts	Total exposures covered by recognised
		Rated	Unrated	Rated	Unrated				
On-balance sheet									
Sovereign	-	-	572	-	-	-	-	-	-
Public sector entity	14,239	13,168	1,073	1,494	215	1,709	-	-	-
Multilateral development bank	24,870	24,870	-	-	-	-	-	-	-
Bank	5	-	250	-	124	124	-	-	-
Securities firm	-	-	-	-	-	-	-	-	-
Corporate	14,118	1	12,321	1	12,321	12,322	989	808	
Collective investment scheme	-	-	-	-	-	-	-	-	-
Cash items	-	-	-	-	-	-	-	-	-
Regulatory retail	2,293	-	1,680	-	1,260	1,260	602	11	
Residential mortgage loan	17,836	-	17,802	-	9,976	9,976	32	1	
Other exposures which are not past due									
exposures	3,890	-	1,584	-	1,584	1,584	2,307	-	
Past due exposures	212	-	212	-	300	300	26	-	
	77,463	38,039	35,494	1,495	25,780	27,275	3,956	820	
Off-balance sheet									
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	1,833	-	1,074	-	836	836	759	19	
OTC derivative contracts	237	-	237	-	226	226	-	-	
Credit derivative contracts	-	-	-	-	-	-	-	-	
Other off-balance sheet exposures not elsewhere specified	-	-	-	-	-	-	-	-	
	2,070	-	1,311	-	1,062	1,062	759	19	
Total	79,533	38,039	36,805	1,495	26,842	28,337	4,715	839	
Exposures deducted from capital base									
	—	—	—	—	—	—	—	—	

* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

4 Credit risk under the standardised (credit risk) approach (continued)

(c) Credit risk exposures under the standardised (credit risk) approach (continued)

2012

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	Total exposures covered by recognised collateral
		Exposures after recognised credit risk mitigation		Risk-weighted amounts					
		Rated	Unrated	Rated	Unrated				
On-balance sheet									
Sovereign	-	-	568	-	-	-	-	-	-
Public sector entity	13,024	12,908	118	1,352	23	1,375	-	-	-
Multilateral development bank	24,095	24,095	-	-	-	-	-	-	-
Bank	15	-	15	-	6	6	-	-	-
Securities firm	33	-	33	-	17	17	-	-	-
Corporate	5,692	1	4,317	1	4,317	4,318	828	546	
Collective investment scheme	39	-	39	-	39	39	-	-	-
Cash items	-	-	-	-	-	-	-	-	-
Regulatory retail	2,497	-	1,836	-	1,377	1,377	639	23	
Residential mortgage loan	13,818	-	13,779	-	7,227	7,227	37	1	
Other exposures which are not past due									
exposures	4,137	-	1,781	-	1,781	1,781	2,357	-	
Past due exposures	219	-	219	-	315	315	2	-	
	63,569	37,004	22,705	1,353	15,102	16,455	3,863	570	
Off-balance sheet									
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	1,552	-	1,326	-	1,317	1,317	226	22	
OTC derivative contracts	223	1	222	-	205	205	1	-	
Credit derivative contracts	-	-	-	-	-	-	-	-	
Other off-balance sheet exposures not elsewhere specified	-	-	-	-	-	-	-	-	
	1,775	1	1,548	-	1,522	1,522	227	22	
Total	65,344	37,005	24,253	1,353	16,624	17,977	4,090	592	
Exposures deducted from capital base									
	—	—	—	—	—	—	—	—	

* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

5 Counterparty credit risk-related exposures

(a) In respect of counterparty credit risk exposures which arises from over-the-counter ("OTC") derivative transactions and repo-style transactions (referred as "relevant transaction") hereunder, credit limit to counterparty credit risk arising from the relevant transaction is assigned, monitored and reported in accordance with the Group risk methodology. The credit limit established takes into account the gross contract amount and the future potential exposure measured on the basis of 95 percentile potential worst case loss estimates for the product involved. This method of calculating credit limit applies to all counterparties.

Credit equivalent amount and risk-weighted amount of relevant transaction is determined following the regulatory capital requirements. Risk-weighted amount is calculated in accordance with the counterparty risk weighting as per internal ratings-based approach/standardised (credit risk) approach under the Capital Rules.

The policy for secured collateral on derivatives is guided by the Group's internal Best Practice Guidelines ensuring the due-diligence necessary to fully understand the effectiveness of netting and collateralisation by jurisdiction, counterparty, product and agreement type is fully assessed and that the due-diligence standards are high and consistently applied. The Group's policies for establishing provisions are discussed in note 3(d) to the financial statements - Loan impairment.

Under the terms of our current collateral obligations under derivative contracts, we estimate based on the positions as at 31 December 2013 that the Bank would not be required to post additional collateral in the event of one or two notch downgrade in the Bank's credit ratings (2012: nil).

Wrong-way risk is an aggravated form of concentration risk and arises when there is a strong correlation between the counterparty's PD and the mark-to-market value of the underlying transaction. The Group uses a range of procedures to monitor and control wrong-way risk, including requiring front offices to obtain prior approval before undertaking wrong way risk transactions outside pre-agreed guidelines.

(b) Counterparty credit risk exposures

The following tables show the counterparty credit risk exposures under the internal-ratings based approach and standardised (credit risk) approach. There were no outstanding repo-style transactions and credit derivative contracts at 31 December 2013 (2012: Nil).

(i) Counterparty credit risk exposures under the internal-ratings based approach

	2013	2012
OTC derivative transactions:		
Gross total positive fair value which are not repo-style transactions	6,110	4,551
Credit equivalent amount	<u>10,307</u>	8,902
Value of recognised collateral by type:		
Debt securities	-	-
Others	<u>22</u>	198
	<u><u>22</u></u>	<u><u>198</u></u>
Credit equivalent amount or net credit exposures net of recognised collateral*		
	<u><u>10,307</u></u>	<u><u>8,902</u></u>
Risk-weighted amount		
	<u><u>4,294</u></u>	<u><u>2,684</u></u>
Notional amount of recognised credit derivative contracts which provide credit protection		
	<u><u>-</u></u>	<u><u>-</u></u>

*For OTC derivative contracts, the recognised collateral is reflected in LGD.

(ii) Counterparty credit risk exposures under the standardised (credit risk) approach

	2013	2012
OTC derivative transactions:		
Gross total positive fair value which are not repo-style transactions	86	55
Credit equivalent amount	<u>237</u>	223
Value of recognised collateral by type:		
Debt securities	-	-
Others	<u>-</u>	<u>-</u>
	<u><u>-</u></u>	<u><u>-</u></u>
Credit equivalent amount or net credit exposures net of recognised collateral held		
	<u><u>237</u></u>	<u><u>222</u></u>
Risk-weighted amount		
	<u><u>226</u></u>	<u><u>204</u></u>
Notional amount of recognised credit derivative contracts which provide credit protection		
	<u><u>-</u></u>	<u><u>-</u></u>

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

5 Counterparty credit risk-related exposures (continued)

(c) Major classes of exposures by counterparty type

(i) Major classes of exposures under the internal ratings-based approach by counterparty type

	2013			2012		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
Sovereign	-	-	-	-	-	-
Public sector entities	-	-	-	-	-	-
Banks	734,118	6,700	1,221	756,161	6,714	861
Corporates	136,740	3,607	3,073	129,148	2,188	1,823
	870,858	10,307	4,294	885,309	8,902	2,684

(ii) Major classes of exposures under the standardised (credit risk) approach by counterparty type

	2013			2012		
	Contract amount	Credit equivalent amount	Risk-weighted amount	Contract amount	Credit equivalent amount	Risk-weighted amount
Sovereign	-	-	-	-	-	-
Public sector entities	-	-	-	39	1	-
Banks	-	-	-	-	-	-
Corporates	6,670	237	226	6,275	222	204
	6,670	237	226	6,314	223	204

The Group had no credit exposures that are risk-weighted at 1250% at 31 December 2013 (2012: Nil).

6 Asset securitisation

There was no asset securitisation for which the Group is an originating institution or an investing institution at 31 December 2013 (2012: Nil).

7 Market risk

(a) The Hong Kong Monetary Authority has granted approval under sections 18(2)(a) and 18(5) of the Capital Rules for the Group to use the internal models approach to calculate its market risk for foreign exchange risk and general interest rate risk. Standardised approach is used for the calculation of specific interest rate risk, equity risk and commodity risk.

	2013	2012
Market risk calculated by:		
- Internal models approach:		
-- VAR	49	72
-- Stressed VAR	278	101
- Standardised approach:		
-- specific interest rate exposures	17	23
-- equity exposures	-	-
Total capital charge for market risk	344	196

Capital charge means an amount of regulatory capital which the Group is required to hold for an exposure to a relevant risk which, if multiplied by 12.5, becomes the risk-weighted amount of that exposure for that risk.

(b) Methodology for valuation of market risk position under internal model approach

VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. A Historical Simulation approach is used to model foreign currency and interest rate risk. Standard 1-day VAR is generated by revaluing the portfolio for each of 500 historical scenarios from one-day market movements, and is derived from a clean two-year time series of historic market risk factor data. Apart from the standard 1-day VAR, the Group has introduced stressed VAR since the start of 2012 according to the Basel 2.5 requirement. Stressed VAR is the measure of VAR using a continuous one-year historical period of significant stress for the trading portfolio, assuming a 10-day holding period.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

7 Market risk (continued)

(c) Characteristics and coverage of VAR model

The VAR models cover all material sources of price risk relating to foreign exchange risk and general interest rate risk. Foreign exchange risk factors include, but are not limited to, foreign currency prices and foreign currency option volatility. General interest rate risk factors include, but are not limited to, interest rate curves and interest rate option volatilities.

Historical simulation approach is used for all outright interest rate and foreign exchange in VAR calculation. Standard VAR uses a 99% confidence interval and a one day time horizon based on 500 historical scenarios. The result is then scaled up to a ten day holding period. Stressed VAR uses a 10-day holding period and a 99% confidence interval based on a continuous one-year historical significant stress period.

Historical, hypothetical and technical scenario stress testing is performed on positions on a bi-weekly basis. Back-testing of the interest rate and foreign exchange uses clean and hypothetical profits and losses from trading operations and compares these to overall and individual business level VAR on a daily basis.

8 Operational risk

The Hong Kong Monetary Authority has granted approval under section 25(2) of the Capital Rules for the Group to use the standardised approach to calculate its operational risk.

	2013	2012
Capital charge for operational risk	<u>3,288</u>	<u>3,026</u>

9 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 3(g)(i) and 3(h) 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.

	2013	2012
Cumulative realised gains on disposal	-	1
Unrealised (losses)/gains:		
- recognised in reserve but not through the income statement	(1,521)	273
- amount included in supplementary capital ¹	-	123

¹ Comparative analysis for 2013 is not applicable following the implementation of the new regulatory capital calculation under Basel III.

10 Disclosure for selected exposure

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)

11 Analysis of gross loans and advances to customers by categories based on internal classification used by the Group

Gross advances, impaired advances, individually assessed and collectively assessed loan impairment allowances, 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 loans and advances to customers are analysed as follows:

	Group						
	Gross advances	Overdue advances	Impaired advances	Individually assessed loan impairment allowances	Collectively assessed loan impairment allowances	New impairment allowances	Advances written off during the year
2013							
Residential mortgages	159,094	54	119	(7)	-	9	-
Commercial, industrial and international trade	155,392	620	931	(691)	(533)	341	69
Commercial real estate	79,670	26	1	-	(3)	-	-
Other property-related lending	93,664	-	47	(1)	(13)	3	1
2012							
Residential mortgages	150,812	33	137	(2)	(16)	3	1
Commercial, industrial and international trade	137,259	720	939	(662)	(558)	428	274
Commercial real estate	72,379	17	8	-	(5)	1	-
Other property-related lending	85,821	25	54	(3)	(17)	12	2

12 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 Hong Kong Monetary Authority under the Banking (Disclosure) Rules with reference to the Hong Kong Monetary Authority 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
2013				
Mainland entities	53,711	8,672	62,383	-
Companies and individuals outside Mainland where the credit is granted for use in Mainland	29,968	4,442	34,410	39
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	153 83,832 <u>73,396</u> <u>157,228</u>	- 13,114 10,747 <u>23,861</u>	153 96,946 84,143 <u>181,089</u>	- 39 <u>175</u> <u>214</u>
Exposures incurred by the Bank's mainland subsidiary				
2012 (restated)				
Mainland entities	42,675	8,320	50,995	-
Companies and individuals outside Mainland where the credit is granted for use in Mainland	22,458	3,580	26,038	132
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	130 65,263 <u>61,912</u> <u>127,175</u>	- 11,900 7,950 <u>19,850</u>	130 77,163 69,862 <u>147,025</u>	- 132 176 <u>308</u>
Exposures incurred by the Bank's mainland subsidiary				

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

13 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
2013				
Asia-Pacific excluding Hong Kong:				
- China	84,678	-	58,957	143,635
- Japan	12,876	-	25,847	38,723
- Other	42,749	2,838	19,808	65,395
	140,303	2,838	104,612	247,753
The Americas:				
- United States	4,036	-	7,468	11,504
- Other	3,563	1,514	17,047	22,124
	7,599	1,514	24,515	33,628
Europe:				
- United Kingdom	7,150	-	2,834	9,984
- Other	12,731	7,394	9,269	29,394
	19,881	7,394	12,103	39,378
2012				
Asia-Pacific excluding Hong Kong:				
- China	78,682	-	37,256	115,938
- Japan	14,763	-	26,004	40,767
- Other	46,810	1,356	16,125	64,291
	140,255	1,356	79,385	220,996
The Americas:				
- United States	3,997	-	4,615	8,612
- Other	9,317	1,680	18,139	29,136
	13,314	1,680	22,754	37,748
Europe:				
- United Kingdom	11,091	-	5,928	17,019
- Other	20,296	5,408	13,725	39,429
	31,387	5,408	19,653	56,448

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

14 Foreign currency exposure

At 31 December 2013, the US dollar ("USD"), Chinese renminbi ("RMB"), Euro ("EUR") and Australian dollar ("AUD") were the currencies in which the Group had non-structural foreign currency positions that were not less than 10% of the total net position in all foreign currencies. The Group also had a RMB structural foreign currency position, which was not less than 10% of the total net structural position in all foreign currencies.

The tables below summarise the net structural and non-structural foreign currency positions of the Group.

	Group					
	USD	RMB	EUR	AUD	Other foreign currencies	Total foreign currencies
2013						
Non-structural position						
Spot assets	176,324	157,293	4,807	20,569	44,217	403,210
Spot liabilities	(154,695)	(137,449)	(7,621)	(26,347)	(32,777)	(358,889)
Forward purchases	287,769	132,637	7,320	13,358	28,817	469,901
Forward sales	(310,493)	(150,555)	(4,610)	(7,658)	(40,072)	(513,388)
Net options position	404	(146)	-	(15)	(215)	28
Net long/(short) non-structural position	(691)	1,780	(104)	(93)	(30)	862
Structural position	205	37,530	-	-	535	38,270
2012						
Non-structural position						
Spot assets	160,217	119,957	18,553	50,739	74,895	424,361
Spot liabilities	(144,015)	(112,827)	(10,637)	(50,157)	(47,997)	(365,633)
Forward purchases	301,222	83,737	7,280	8,503	18,791	419,533
Forward sales	(313,787)	(90,096)	(15,227)	(9,028)	(45,669)	(473,807)
Net options position	160	(142)	19	82	(93)	26
Net long/(short) non-structural position	3,797	629	(12)	139	(73)	4,480
Structural position	205	30,375	-	-	434	31,014

ANALYSIS OF SHAREHOLDERS

As at 31 December 2013	Shareholders		Shares of HK\$5 each	
	Number	Percentage of total	Number in millions	Percentage of total
Number of shares held				
1 - 500	6,688	33.42	1.6	0.08
501 - 2,000	6,335	31.65	7.8	0.41
2,001 - 5,000	3,322	16.60	11.5	0.60
5,001 - 20,000	2,789	13.94	28.6	1.50
20,001 - 50,000	572	2.86	17.9	0.94
50,001 - 100,000	164	0.82	11.7	0.61
100,001 - 200,000	80	0.40	11.4	0.60
Over 200,000	62	0.31	1,821.3	95.26
	20,012	100.00	1,911.8	100.00

Geographical Distribution

Hong Kong	19,694	98.41	1,908.7	99.84
Malaysia	66	0.33	0.4	0.02
Canada	51	0.26	0.1	0.01
United States of America	40	0.20	0.3	0.01
Singapore	40	0.20	2.0	0.10
United Kingdom	32	0.16	0.0	0.00
Australia	32	0.16	0.1	0.00
Macau	31	0.15	0.1	0.01
Others	26	0.13	0.1	0.01
	20,012	100.00	1,911.8	100.00

SUBSIDIARIES *

Everlasting International Limited
Fulcher Enterprises Company 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 Data Services Limited
Hang Seng Finance Limited
Hang Seng Financial Information Limited
Hang Seng Futures Limited
Hang Seng Indexes Company Limited
Hang Seng Insurance Company 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
High Time Investments Limited
HSI International Limited
Imenson Limited
Yan Nin Development Company Limited

* As defined in Section 2 of Hong Kong Companies Ordinance.

CORPORATE INFORMATION AND CALENDAR

CORPORATE INFORMATION

BOARD OF DIRECTORS

Chairman

Raymond K F Ch'ien GBS, CBE, JP

Vice-Chairman

Rose W M Lee

Directors

John C C Chan GBS, JP

Nixon L S Chan

Marvin K T Cheung GBS, OBE, JP

L Y Chiang JP

Andrew H C Fung JP

Fred Ziliu Hu

Sarah C Legg

Eric K C Li GBS, OBE, JP

Vincent H S Lo GBS, JP

Richard Y S Tang BBS, JP

Peter T S Wong JP

Michael W K Wu

Secretary

C C Li

REGISTERED OFFICE

83 Des Voeux Road Central, Hong Kong

Website: www.hangseng.com

Email: hangseng@computershare.com.hk

STOCK CODE

The Stock Exchange of Hong Kong Limited: 11

REGISTRAR

Computershare Hong Kong Investor Services Limited

Shops 1712-1716, 17th Floor, Hopewell Centre

183 Queen's Road East, Wanchai, Hong Kong

DEPOSITORY *

BNY Mellon Shareowner Services

PO Box 30170

College Station, TX 77842-3170, USA

Telephone: 1-201-680-6825

Toll free (domestic): 1-888-BNY-ADRS

Website: www.mybnymdr.com

Email: shrelations@cpushareownerservices.com

* The Bank offers investors in the United States a Sponsored Level-1 American Depository Receipts Programme through The Bank of New York Mellon Corporation.

ANNUAL REPORT 2013

This Annual Report 2013 in both English and Chinese is now available in printed form and on the Bank's website (www.hangseng.com) and the website of Hong Kong Exchanges and Clearing Limited ("HKEx") (www.hkexnews.hk).

Shareholders who:

- A) browse this Annual Report 2013 on the Bank's website and wish to receive a printed copy; or
 - B) receive this Annual Report 2013 in either English or Chinese and wish to receive a printed copy in the other language version,

may send a request form, which can be obtained from the Bank's Registrar or downloaded from the Bank's website (www.hangseng.com) or HKEx's website (www.hkexnews.hk), to the Bank's Registrar:

Computershare Hong Kong Investor Services Limited
17M Floor, Hopewell Centre
183 Queen's Road East
Wanchai, Hong Kong
Facsimile: (852) 2529 6087
Email: hangseng@computershare.com.hk

If shareholders who have chosen (or are deemed to have chosen) to read this Annual Report 2013 on the Bank's website have difficulty in reading or gaining access to this Annual Report 2013 via the Bank's website for any reason, the Bank will promptly send this Annual Report 2013 in printed form free of charge upon the shareholders' request.

Shareholders may change their choice of means of receipt or language of the Bank's future corporate communications at any time, free of charge, by giving the Bank c/o the Bank's Registrar reasonable notice in writing or by email to hangseng@computershare.com.hk.

CALENDAR

2013 Full Year Results

Announcement date 24 February 2014

2013 Fourth Interim Dividend*

Announcement date	24 February 2014
Book close and record date	12 March 2014
Payment date	27 March 2014

2013 Annual Report

to be posted to shareholders in late March 2014

Annual General Meeting

to be held on 9 May 2014

Tentative date for 2014 Half Year Results

Announcement date 4 August 2014

2014 Interim Report

tentative to be posted to shareholders in late August 2014

- * The Register of Shareholders of the Bank will be closed on Wednesday, 12 March 2014, 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 Registrar, Computershare Hong Kong Investor Services Limited, at Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai,

Hong Kong, for registration not later than 4:30 pm on Tuesday, 11 March 2014. The fourth interim dividend will be payable on Thursday, 27 March 2014 to shareholders on the Register of Shareholders of the Bank on Wednesday, 12 March 2014. Shares of the Bank will be traded ex-dividend as from Monday, 10 March 2014.