BASE LISTING DOCUMENT

Non-collateralised Structured Products

Base Listing Document relating to Hong Kong Listed Structured Products

to be issued by

HSBC

The Hongkong and Shanghai Banking Corporation Limited

(incorporated in Hong Kong with limited liability under the Companies Ordinance of Hong Kong)

The Hongkong and Shanghai Banking Corporation Limited (the "**Issuer**", "**we**" or "**us**") has published this document in respect of call/put warrants on single equities ("**Equity Warrants**"), call/put warrants on indices ("**Index Warrants**") and call/put warrants on unit funds ("**Unit Fund Warrants**") (together the "**Warrants**"), callable bull/bear contracts on single equities ("**Equity Callable Bull/Bear Contracts**"), callable bull/bear contracts on indices ("**Index Callable Bull/Bear Contracts**") and callable bull/bear contracts on unit funds ("**Unit Fund Callable Bull/Bear Contracts**") (together the "**CBBCs**" and, together with the Warrants and any other structured products approved by The Stock Exchange of Hong Kong Limited (the "**stock exchange**") from time to time, the "**structured products**") to be issued by us in series (each a "**series**") from time to time and listed on the stock exchange.

Hong Kong Exchanges and Clearing Limited ("**HKEx**") and the stock exchange and Hong Kong Securities Clearing Company Limited ("**HKSCC**") take no responsibility for the contents of this document, make no representation as to its accuracy or completeness and expressly disclaim any liability whatsoever for any loss howsoever arising from or in reliance upon the whole or any part of the contents of this document.

This document, for which we accept full responsibility, includes particulars given in compliance with the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "**rules**") for the purpose of giving information with regard to us and the structured products. We, having made all reasonable enquiries, confirm that to the best of our knowledge and belief the information contained in this document is accurate and complete in all material respects and not misleading or deceptive, and there are no other matters the omission of which would make any statement herein or this document misleading. Additional terms relating to each series of our structured products will be set out in a supplemental listing document (each a "**supplemental listing document**") which will be supplemental to, and should be read in conjunction with, this document.

The structured products involve derivatives. You should not invest in the structured products unless you fully understand and are willing to assume the risks associated with the structured products. You are warned that the price of our structured products may fall in value as rapidly as it may rise and you may sustain a total loss of your investment. Prospective purchasers should therefore ensure that they understand the nature of our structured products and carefully study the risk factors set out in this base listing document and the relevant supplemental listing document and, where necessary, seek professional advice, before they invest in any of our structured products. The Issuer is part of a large global financial institution and has many financial products and contracts outstanding at any given time.

The structured products constitute general unsecured contractual obligations of the Issuer and of no other person and will rank equally among themselves and with all of the Issuer's other unsecured obligations (save for those obligations preferred by law) upon liquidation. If you purchase the structured products, you are relying upon the Issuer's creditworthiness and have no rights under the structured products against (a) any company which has issued the underlying asset, (b) the trustee or the manager of the underlying fund, or (c) the index compiler of any underlying index or any other person. If the Issuer becomes insolvent or defaults on its obligations under the structured products, you may not be able to recover all or even part of the amount due under the structured products (if any).

Dated 29 April 2013

IMPORTANT

If you are in any doubt as to any of the contents of this document, you should consult your stockbroker or other registered dealer in securities, bank manager, solicitor, professional accountant or other professional adviser.

If at the time of issue of the structure products, any information in this base listing document needs to be updated, we will either include the updated information in the relevant supplemental listing document or publish an addendum to this base listing document.

You should read this document, together with any addendum to it and the relevant supplemental listing document, before deciding whether to invest in the structured products.

We cannot give you investment advice. You must decide for yourself whether our structured products meet your investment needs, and obtain independent professional advice if appropriate. This document is not intended to be, and should not be considered as, a recommendation or advice by us or any of our affiliates that you should purchase any of our structured products, and you must make your own independent investigation of our financial condition and affairs and your own appraisal of our creditworthiness.

We undertake during the period in which our structured products are listed on the stock exchange to make the following documents available to you for inspection at the office of The Hongkong and Shanghai Banking Corporation Limited, which is presently at HSBC Main Building, 1 Queen's Road Central, Hong Kong:

(a) a copy of this document and any addendum to this document (both the English version and the Chinese translation);

(b) a copy of our latest publicly available annual report (both the English version and the Chinese translation) and interim report (if any); and

(c) copies of the consent letters of our auditors referred to in this document.

本公司保證下列文件可於結構性產品在聯交所上市的期間內在香港上海滙豐銀行有限公司辦事處(地址為香港皇后大道中1號香港上海滙豐銀行總行大廈)查閱:

(a) 本文件及本文件的任何增編(英文版本及中文譯本);

(b) 本公司最近期可供查閱的年報(英文版本及中文譯本)及中期報告(如有);及

(c) 本文件所述本公司核數師的同意函件。

Our structured products are not available to U.S. persons (as defined in the U.S. Securities Act of 1933, as amended).

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OVERVIEW OF OUR PROGRAMME

We have set up this **programme** for the purpose of offering from time to time to the public in Hong Kong **structured products** listed on the stock exchange. The following is an overview of the main features of the programme.

Who issues the structured products?	The Hongkong and Shanghai Banking Corporation Limited is the **Issuer** of the structured products. References in this base listing document to "**we**", "**our**" and "**us**" are to the Issuer.
Will the structured products be guaranteed?	No.
What types of structured products may we issue under the programme?	We may issue Warrants and CBBCs under the programme, each as described below. We may also issue from time to time under the programme other structured products approved by the stock exchange.
What types of Warrants may be issued under the programme?	The **Warrants** which we may issue under the programme are: (a) call/put warrants on single equities ("**Equity Warrants**"); (b) call/put warrants on a single index ("**Index Warrants**"); and (c) call/put warrants on a single unit fund ("**Unit Fund Warrants**").
What types of CBBCs may be issued under the programme?	The callable bull/bear contracts (the "**CBBCs**") which we may issue under the programme are: (a) callable bull/bear contracts on single equities ("**Equity Callable Bull/Bear Contracts**"); (b) callable bull/bear contracts on a single index ("**Index Callable Bull/Bear Contracts**"); and (c) callable bull/bear contracts on a single unit fund ("**Unit fund Callable Bull/Bear Contracts**").
How are the structured products issued?	Our structured products will be issued in one or more **series**. Structured products within a series will have the same terms, but the terms of one series of structured products may be different from another.
What is the legal status of the structured products?	The structured products are our direct, unconditional, unsubordinated and unsecured obligations, ranking equally (*pari passu*) among themselves and with all our other present and future direct, unconditional, unsecured and unsubordinated obligations (save for those obligations preferred by law).

Will the structured products be listed?	Yes. We will apply to the stock exchange to list each series of the structured products which we issue under the programme. This base listing document has been published for the purposes of obtaining a listing of each series of structured products which we issue under the programme.
Will the structured products be admitted to CCASS?	Yes. We will make arrangements to ensure that each series of structured products will be accepted by the HKSCC as eligible securities for deposit, clearance and settlement in the Central Clearing and Settlement System ("**CCASS**"). All activities under CCASS are subject to the General Rules of CCASS and CCASS Operational Procedures in effect from time to time (the "**CCASS Rules**").
What are the listing documents for the structured products?	We have published this base listing document to permit the listing of our structured products on the stock exchange. This base listing document sets out the terms and conditions of the structured products, common features of the structured products, the legal terms relating to the programme and information about us. This base listing document includes particulars given in compliance with the rules for the purpose of giving information with regard to us and the structured products. When we apply to list one or more series of structured products, we will publish a **supplemental listing document**, which will include information on the particular structured products to be listed. The supplemental listing document will be available in English and Chinese versions (which may be printed together in the same document). If any information in this base listing document needs to be updated at the time we issue a supplemental listing document, we will either include the updated information in the relevant supplemental listing document or publish an addendum to this base listing document.
What will a supplemental listing document specify?	The supplemental listing document will, amongst other things, set out the terms of the series of structured products being offered to supplement the applicable set of master terms and conditions in this base listing document, which will include the following:
Type of structured product	The supplemental listing document will specify the type of the series of structured products offered.
Exercise	The supplemental listing document will specify the date on which the structured products may be exercised. The structured products which we issue under the programme may be exercised only upon the specified expiry date.
Settlement Basis	The holder of the structured products will be entitled to a cash payment upon exercise (assuming that the cash payment is greater than zero).
Issue price	The supplemental listing document will specify the issue price of the structured product.

Underlying

The supplemental listing document will specify the **underlying** for the structured product, which may be a share, an index or a fund.

Expiry Date

The supplemental listing document will specify the expiry date for the series of structured products offered.

Liquidity Provider

The supplemental listing document will specify the name and contact details of the liquidity provider appointed for the series of structured products offered, and the basis on which the appointed liquidity provider will provide liquidity in the relevant structured products.

How will the structured products be represented?

The structured products of each series will be issued in registered form and represented by a global certificate which will be registered in the name of HKSCC Nominees Limited (or such other nominee company as HKSCC may specify from time to time) and will be deposited with CCASS in accordance with the CCASS Rules.

Will you get any individual certificate representing an investment in a series of our structured products?

No, you will not receive any individual certificates.

In the Terms and Conditions for the structured products, there are references to "holders". Who are they?

The Issuer will maintain a register showing the details of each person who is entitled to a particular number of structured products of a series. The person registered will be treated by us as the absolute owner and **holder** of that number of structured products.

The register for each series of structured products will record at all times that HKSCC Nominees Limited (or such other nominee company as HKSCC may specify for that series) is the holder of 100 per cent. of the structured products of that series.

Accordingly you will not be recognised by us as the holder of the structured products in which you invest, and you must refer to the records of CCASS and/or your custodian/broker, and the statements that you receive, to determine your beneficial interest in the structured products.

How do we give notices and make payments under our structured products?

We will give any necessary notices by publishing such notices in English and in Chinese on the website of HKEx, or otherwise in accordance with the terms and conditions of the relevant structured products.

We will make all payments that are due under our structured products to the registered holder of the structured products. The registered holder will be HKSCC Nominees Limited (or such other nominee company as HKSCC may specify for that series). In this situation, the payments to which you are entitled will be made to you or to your custodian/broker through CCASS in accordance with the CCASS Rules.

Can we repurchase our structured products?

Yes, we or our affiliates may repurchase our structured products at any time. We may offer for sale any structured products which we repurchase, and may do so at prevailing market prices or in negotiated transactions at our discretion (acting in good faith and in a commercially reasonable manner). You should not therefore make any assumptions as to the number of structured products of any series which may be in issue from time to time.

You should carefully consider the following information together with the other information contained in this base listing document (and any applicable addendum) and in the applicable supplemental listing document before purchasing our structured products.

This section highlights only some of the risks of dealing in the structured products but their inclusion in this document does not mean these are the only significant or relevant risks of dealing in our structured products. If you have any concerns or doubts about our structured products, you should obtain independent professional advice.

General Risk Factors relating to us and our Structured Products

(1) Non-collateralised structured products

Our structured products are not secured on any of our assets or any collateral.

(2) You must rely on our creditworthiness

If you purchase our structured products, you rely on our creditworthiness and of no other person and you have no rights under the structured products against any company which has issued the shares (in respect of equity-linked structured products), any company constituting the index or the index compiler (in respect of index-linked structured products), or any manager or trustee of the fund (in respect of unit fund-linked structured products). There is no assurance of protection against a default by us in respect of our obligations under our structured products. If we become insolvent or default on our obligations under the structured products, you can only claim as our unsecured creditor regardless of the performance of the underlying and you may not be able to recover all or even part of the amount due under the structured products (if any).

You should note that rating agencies usually receive a fee from the issuers that they rate. When evaluating our creditworthiness, you should not solely rely on our credit ratings (which are set out in the section headed "General Information" on page 87 of this base listing document and the section headed "Important information" of the relevant supplemental listing document) because:

- a credit rating is not a recommendation to buy, sell or hold our structured products;
- ratings of companies may involve difficult-to-quantify factors such as market competition, the success or failure of new products and markets and managerial competence; and
- a high credit rating is not necessarily indicative of low risk. Our credit ratings as set out in this base listing document and the relevant announcement and supplemental listing document are for reference only. Any downgrading of our ratings could result in a reduction in the value of the structured products.

(3) The structured products are not principal protected and may become worthless

Although the cost of a structured product may cost a fraction of the value of the underlying, the structured product's price may change more rapidly than the price or level of the underlying. Given the gearing feature inherent in the structured products, a small change in the price or level of the underlying may lead to a substantial price movement in the structured products. You may suffer higher losses in percentage terms if you expect the price or level of the underlying to move one way but it moves in the opposite direction. In the worst case, the structured products may become worthless and you will lose all of your investment. The structured products may only be suitable for experienced investors who are willing to accept the risk that they may lose all their investment.

(4) The price of our structured products may fluctuate to a great extent

The price of our structured products may fall or rise rapidly in value and our structured products may expire or become worthless, resulting in a total loss of your investment. Before dealing in our structured products, you should carefully consider, among other things, (i) the prevailing trading price of the structured products; (ii) the value or level and volatility of the underlying; (iii) the time remaining to expiration; (iv) any change(s) in interim interest rates and dividend yields; (v) any change(s) in currency exchange rates; (vi) any related transaction costs; and (vii) our creditworthiness.

(5) The secondary market for our structured products may be limited

We cannot predict if and to what extent a secondary market may develop for the structured products or whether that market will be liquid or illiquid. Whilst we intend to apply to list each series of our structured products on the stock exchange, the fact that a particular series of structured products is listed does not necessarily lead to greater liquidity. In addition, even if a series of structured products is listed on the stock exchange, there can be no assurance that any such listing can be maintained. We (acting through our appointed liquidity provider) may be the only person quoting prices on the stock exchange for the structured products. Therefore, the secondary market may be limited. The more limited the secondary market, the more difficult it may be for you to realise the value in the structured products prior to expiry.

(6) The liquidity provider may not be able to provide liquidity for the structured products

You should also be aware that the appointed liquidity provider may not be able to provide liquidity when there are operational and technical problem hindering its ability to do so. Even if the appointed liquidity provider is able to provide liquidity in such circumstances, its performance of liquidity provision may be adversely affected. For example: (i) the spread between bid and ask prices quoted by the appointed liquidity provider may be significantly wider than its normal standard; (ii) the quantity for which liquidity will be provided by the appointed liquidity provider may be significantly smaller than its normal standard; and/or (iii) the appointed liquidity provider's response time for a quote may be significantly longer than its normal standard.

(7) The structured products constitute our unsecured and unsubordinated contractual obligations

The structured products constitute our general unsecured contractual obligations and of no other person and shall rank equally (*pari passu*) among themselves and with all our other unsecured obligations (save for certain obligations required to be preferred by law). We issue a large number of financial instruments on a global basis. We have substantially no obligation to you other than to pay amounts in accordance with the terms set out in the applicable supplemental listing document. We do not in any respect underwrite or guarantee the performance of any structured product. We shall have the absolute discretion (acting in good faith and in a commercially reasonable manner) to put in place any hedging transaction or arrangement appropriate in connection with any structured product or the applicable underlying.

(8) Trading in the structured products may be affected by suspension of trading in the underlying

If trading in the underlying is suspended on the stock exchange, trading in the structured products may be suspended for a similar period. If trading in the underlying is suspended for a prolonged period, trading in the structured products will be suspended for a similar prolonged period. The "time value" of the structured products will be adversely affected during the prolonged suspension period.

(9) There is a time lag between exercise of the structured products and payment to you

Any delay between exercise of the structured products and payment to you will be specified in the applicable supplemental listing document or in the relevant terms and conditions. We will not compensate you for any loss you suffer as a result of any such time lag.

(10) Time decay

All other factors being equal, the value of a structured product is likely to decrease over time. Therefore, the structured product should not be viewed as a product for long term investments.

(11) The value of the underlying may fluctuate

An investment in our structured products involves risks relating to changes in the value of the underlying. The value of the underlying will vary over time, including as a result of corporate actions (where the underlying is a share) or changes in computation (where the underlying is an index). Certain of such events which affect the value of the underlying may require an adjustment to the structured products. However, even if such event does not require an adjustment to the structured products, the price of our structured products or the return on an investment in our structured products may be affected.

(12) Investments in the structured products are not the same as investments in the underlying

The value of our structured products may not correlate directly with the movements of the underlying and may be affected by the time remaining to expiry. Also, where the underlying is a share, as holder of our structured products you will not have the same rights (including voting rights and rights to dividends) as if you were a direct holder of the underlying.

(13) Gearing effects

Since the structured products are leveraged, the percentage change in the price of a structured product is greater compared with that of the underlying. You may suffer higher losses in percentage terms if you expect the price or level of the underlying to move one way but it moves in the opposite direction.

(14) There could be conflicts of interests which may affect our structured products

Various potential and actual conflicts of interest may arise from our overall activities or activities of our subsidiaries and affiliates. Such actions and conflicts may include, without limitation, the exercise of voting power, the purchase and sale of securities, financial advisory relationships and exercise of creditor rights. Such activities, information and/or research reports may involve or affect the company which has issued the underlying asset and/or the underlying asset and may cause consequences adverse to you or otherwise create conflicts of interests in connection with the issue of the structured products. We have no obligation to disclose such information and may issue research reports and engage in any such activities without regard to the issue of the structured products. In the ordinary course of our business, we and our subsidiaries and affiliates may effect transactions on our own account or for the account of our customers and may enter into one or more transactions with respect to the company which has issued the underlying asset and/or the underlying asset or related derivatives this may indirectly affect your interests.

(15) Our structured products will be issued in global registered form

Our structured products are issued in global registered form and are held within CCASS. This means that evidence of your interest in the structured products, and the efficiency of the ultimate payment of any cash settlement amount will be governed by the CCASS Rules.

Our structured products in global registered form will be registered in the name of a nominee for HKSCC (currently HKSCC Nominees Limited), who will be treated by us as the holder of the structured products. You are not entitled to any definitive certificates representing your beneficial interests in the structured products. You will have to rely on CCASS and/or your custodian/broker to (a) determine your beneficial interest in the structured products, (b) receive announcements and/or information relating to the structured products and (c) receive any payments under the structured products. Our obligation to you will be duly performed by the delivery of the cash settlement amount (less any exercise expenses) to HKSCC Nominees Limited as the registered holder of the structured products in accordance with the relevant terms and conditions of the structured products. The amounts will be delivered to you or your custodian/broker through CCASS in accordance with the CCASS Rules.

(16) There may be exchange rate risks and interest rate risks

You should note that there may be exchange rate risks. For example, the underlying may be denominated in a currency other than that of our structured products, our structured products may be denominated in a currency other than the currency of your home jurisdiction and our structured products may settle in a currency other than the currency in which you wishes to receive funds.

Changes in the exchange rate(s) between the currency of the underlying, the currency in which the structured products settle and/or the currency of your home jurisdiction may adversely affect the return of your investment in the structured products. We cannot assure that current exchange rates at the issue date of the structured products will be representative of the future exchange rates used in computing the value of our structured products. Fluctuations in exchange rates may therefore affect the value of the structured products.

In addition, you should be aware that an investment in the structured products may involve interest rate risks in that the intrinsic value of a structured product may be sensitive to fluctuations in interest rates. Interest rates are determined by factors of supply and demand in the international money markets which are affected by macroeconomic factors, speculation and central bank and government intervention. Fluctuations in interest rates (whether short term or long term, and whether of the currency in which the structured products are settled or of the currency in which the underlying is denominated) may affect the value of the structured products.

(17) There may be certain events relating to an index underlying that affect index linked structured products

In the case of index-linked structured products, the level of the index may vary over time and may increase or decrease due to various factors including changes in the formula for or the method of calculating the index. In addition, a level for the index may be published by the index compiler (as defined in the relevant terms and conditions) at a time when one or more shares comprised in the relevant index are not trading. If this occurs on a valuation date (as defined in the relevant terms and conditions) and there is no market disruption event (as defined in the relevant terms and conditions) under the terms of the relevant index-linked structured products, then the closing level of the index will be calculated by reference to the remaining shares comprised in the relevant index. Certain events relating to the index permit us to determine the level of the index on the basis of the formula or method last in effect prior to the changes to such change or formula.

(18) Two or more risk factors may simultaneously affect the structured products

Two or more risk factors may simultaneously have an effect on the value of a structured product such that the effect of any individual risk factor may not be predicted. No assurance can be given as to the effect any combination of risk factors may have on the value of a structured product.

(19) We are not the holding company of the group to which we belong

We are not the ultimate holding company of the group to which we belong and with which our name is identified. The ultimate holding company of the group to which we belong is HSBC Holdings plc.

(20) U.S. Foreign Account Tax Compliance Withholding

We and other financial institutions through which payments on the structured products are made may be required to withhold U.S. tax at a rate of 30 per cent. on all, or a portion of, payments made after the later of 31 December 2016 or the date on which final U.S. Treasury Regulations defining the term "foreign passthru payments" are filed with the U.S. Federal Register in respect of (i) any structured products characterised as debt (or which are not otherwise characterised as equity and have a stated expiration or term) for U.S. federal tax purposes that are issued after (or are materially modified after) the later of (x) 31 December 2013 or (y) six months after the date on which final U.S. Treasury Regulations defining the term "foreign passthru payments" are filed with the U.S. Federal Register and (ii) any structured products characterised as equity or which do not have a stated expiration or term for U.S. federal tax purposes, whenever issued, pursuant to Sections 1471 through 1474 of the U.S. Internal Revenue Code ("**FATCA**") or similar law implementing an intergovernmental approach to FATCA.

In addition, we and other financial institutions through which payments on the structured products are made may be required to withhold U.S. tax pursuant to FATCA at a rate of 30 per cent. on payments made after 31 December 2013 in respect of any structured products characterised as debt (or which are not otherwise characterised as equity and have a stated expiration or term) for U.S. federal tax purposes that are issued after six months after the date on which such products give rise to "dividend equivalent" payments as described below under "Legislation Affecting Dividend Equivalent Payments" or are materially modified from that date.

This withholding tax may apply to an investor or to any non-U.S. financial institution through which payment on the structured products is made if that investor or financial institution is not in compliance with FATCA. Structured product holders therefore may receive less settlement amount than expected. We are not required to pay any additional amounts with respect to amounts so withheld.

FATCA is particularly complex and its application is uncertain at this time. The application of FATCA to structured products issued after 31 December 2013 (or whenever issued, in the case of structured products characterised as equity or without a stated expiration or term for U.S. federal tax purposes) may be addressed in the relevant supplemental listing document or a supplement to this base listing document, as applicable.

Further information on FATCA may be found at www.irs.gov/businesses/corporations/ under the section headed "Foreign Account Tax Compliance Act (FATCA)". Any information appearing on such website does not form part of this base listing document.

(21) Changes in the landscape of financial sector regulation

The global landscape of financial sector regulation is undergoing significant change. In the U.S., the Dodd-Frank Act expands regulatory responsibilities for existing agencies. The extensive programme of regulatory change carries significant implementation risks for authorities and industry participants. Many official measures are proposals in development and negotiation, and have yet to be enacted into regional and national legislation. These processes could result in differing, fragmented and overlapping implementation around the world, leading to risks of regulatory arbitrage, a far from level competitive playing field and increased compliance costs. Any regulatory changes may affect our ability to perform our obligations under the structured products or to continue to issue structured products under the programme. See the section headed "Taxation" on page 85 of this base listing document for further information.

(22) We may early terminate the structured products on the grounds of illegality or impracticability

We are entitled to terminate the structured products if we determine in good faith and in a commercially reasonable manner that, for reasons beyond our control, it has become or it will become illegal or impracticable for us to perform our obligations under the structured products, in whole or in part, as a result of a change in law event (as defined in the relevant terms and conditions), or for us or any of our affiliates to maintain our hedging arrangements with respect to the structured products due to a change in law event.

Upon the occurrence of a change in law event, we will, if and to the extent permitted by applicable law or regulation, pay to you a cash amount that we determine in good faith and in a commercially reasonable manner to be the fair market value in respect of each structured product held by you immediately prior to such termination (ignoring such illegality or impracticability) less the cost to us of unwinding any related hedging arrangement and any charges or expenses including any taxes or duties which are incurred or withheld as we determine in our sole and absolute discretion (acting in good faith and in a commercially reasonable manner). Such amount could be substantially less than the amount you invested and can be as low as zero.

(23) We may adjust the terms and conditions of our structured products upon the occurrence of certain corporate events or extraordinary events affecting the underlying

We may determine that certain corporate events or extraordinary events affecting the underlying have occurred and may make corresponding adjustments to the terms and conditions of our structured products, including adjustments to the value or level of the underlying or changing the composition of the underlying. Such events and/or adjustments (if any) may have an adverse impact on the value and/or market price of our structured products. We may also in our sole discretion adjust the entitlement of our structured products for dilution events such as stock splits and stock dividends.

However, we have no obligation to make an adjustment for every event that can affect the underlying. The value and/or market price of our structured products may be adversely affected by such events in the absence of an adjustment by us. If adjustments were made, we do not assure that such adjustments can negate any adverse impact of such events on the value and/or market price of our structured products.

(24) Modification to the terms and conditions

Under the terms and conditions of the structured products, we may, without the consent of the holder of the structured products, modify the terms and conditions applicable to the structured products if such modification, in our opinion, is (a) not materially prejudicial to the interests of any holder of the structured products generally (without considering circumstances of any individual holder of the structured products or the tax or other consequences of such modification in any particular jurisdiction), (b) of a formal, minor or technical nature, (c) made to correct a manifest error, or (d) necessary in order to comply with mandatory provisions of the laws or regulations of Hong Kong.

(25) Risks in using our structured products for hedging

If you intend to purchase our structured products to hedge against the market risk associated with investing in or having an exposure to any underlying, you should recognise the risks of utilising the structured products in this manner. There is no assurance that the value of the structured products will correlate with movements of the relevant underlying. You may therefore incur substantial losses in the structured products, notwithstanding any losses already incurred with respect to investments in or exposures to the relevant underlying.

(26) Liquidation of the underlying company

In the case of structured products linked to shares, in the event of liquidation or dissolution of the company that issues the underlying shares or the appointment of a liquidator, receiver or administrator or analogous person under Hong Kong law in respect of the whole or substantially the whole of its undertaking, property or assets, the relevant structured products shall lapse.

(27) Liquidation or termination of the underlying trust or fund

In the case of structured products linked to fund units, in the event of (i) a liquidation, dissolution or termination of the fund or (ii) the appointment of a liquidator, receiver or administrator or analogous person under Hong Kong law in respect of the whole or substantially the whole of its undertaking, property or assets or (iii) the withdrawal of the Securities and Futures Commission's authorisation of the fund under the Securities and Futures Ordinance, the relevant structured products shall lapse.

(28) Risks relating to structured products linked to synthetic exchange-traded funds

Some of our structured products may be linked to an exchange-traded fund ("**ETF**"). An ETF is exposed to the political, economic, currency and other risks related to the underlying equity(ies), assets or index that the ETF is designed to track. An ETF is designed to replicate the performance of an underlying index (or in some cases, a group of assets such as commodities). Some ETFs gain exposure to the underlying index by investing in shares, bonds or other assets that make up the index. An increasing number of ETFs, however, adopt a synthetic replication investment strategy to achieve its investment objectives by investing in financial derivative instruments linked to the performance of an underlying asset pool or index that the ETF is designed to track ("**synthetic ETF**"). You should note that:

(a) investments in financial derivative instruments will expose the synthetic ETF to the credit, potential contagion and concentration risks of the counterparties who issued such financial derivative instruments. As such counterparties are predominantly international financial institutions, the failure of one such counterparty may have a negative effect on other counterparties of the synthetic ETF. Even if the synthetic ETF has collateral to reduce the counterparty risk, there may still be a risk that the market value of the collateral has fallen substantially when the synthetic ETF seeks to realise the collateral; and

(b) the synthetic ETF may be exposed to higher liquidity risk if the synthetic ETF invests in financial derivative instruments which do not have an active secondary market.

Accordingly, investing in the structured products is also exposed to the credit risk of the counterparties who issued the derivatives in addition to the risks associated with the underlying index the performance of which the synthetic ETF is designed to replicate. The above risks may have a significant impact on the performance of the synthetic ETF and hence the market price of our structured products.

Risk Factors relating to CBBCs

(29) Our CBBCs could automatically expire worthless in certain circumstances

In the case of CBBCs, you should note that you can lose your entire investment on or prior to the expiry date. Unlike Warrants, CBBCs has a mandatory call feature and trading in the CBBCs will be suspended when the price or level of the underlying reaches the call price or call level (as defined in the relevant terms and conditions) (subject to the circumstances in which a mandatory call event will be reversed as set out in the sub-section titled "A mandatory call event is irrevocable" below). No investors can sell the CBBCs after the occurrence of a mandatory call event. Even if the price or level of the underlying bounces back in the right direction, the CBBCs which have been terminated as a result of the mandatory call event will not be revived and investors will not be able to profit from the bounce-back. Investors may receive a residual value (as defined in the relevant terms and conditions) after the occurrence of a mandatory call event but such amount may be zero. If a mandatory call event occurs, the CBBCs will automatically expire. The CBBCs may become worthless.

(30) The trading price of a CBBC may not be the same as the theoretical value of such CBBC

A CBBC can be terminated when the price or level of the underlying reaches or goes beyond the call price or call level. When the price or level of the underlying approaches the call price or call level (as defined in the relevant terms and conditions), the trading price and theoretical value of the CBBC will likely be more volatile and any change in the trading price of the CBBCs may not be comparable and may be disproportionate with the change in the price or level of the underlying. This is because it is more likely that a mandatory call event will occur.

Once a mandatory call event has occurred in respect of a CBBC, the CBBC will be settled at the residual value (as defined in the relevant terms and conditions) (less exercise expenses), and you will not be able to benefit under that CBBC from any changes to the price or level of the underlying after the occurrence of a mandatory call event.

Further, when you sell your CBBC holdings in the market at any time prior to the expiry of such CBBC, the price realised may not be the same as the theoretical value of the CBBC, as the price will be determined by the levels of supply and demand in the market at that time.

(31) The residual value payable (if any) will not include residual funding cost

The residual value (if any) payable by us following the occurrence of a mandatory call event will not include the residual funding cost for the CBBCs. When a mandatory call event occurs, you will lose the funding cost for the full period.

(32) A mandatory call event is irrevocable

A mandatory call event is irrevocable unless it is triggered due to the occurrence of one of the following events:

(i) report of system malfunction or other technical errors of the stock exchange (e.g. the setting up of the wrong call level or call price or other parameters) by the stock exchange to us; or

(ii) report of manifest errors caused by the relevant third party price sources where applicable (e.g. miscalculation of index level by the index compiler) by us to the stock exchange.

And, in each case, we agree with the stock exchange that such mandatory call event is to be revoked provided that such mutual agreement must be reached no later than 30 minutes before the commencement of trading (including the pre-opening session) (Hong Kong time) on the trading day of the stock exchange immediately following the day on which the mandatory call event occurs, or such other time as prescribed by the stock exchange from time to time.

In such case, the mandatory call event so triggered will be reversed and all trades cancelled (if any) will be reinstated and the trading of the CBBCs will resume.

(33) Delay in mandatory call event notification

We will notify the market as soon as reasonably practicable after the occurrence of a mandatory call event. You should be aware that there may be a delay in our announcement of a mandatory call event due to technical errors, system failures and other factors that are beyond the reasonable control of the stock exchange and us.

(34) Non-Recognition of Post MCE Trades

The stock exchange and its recognised exchange controller, HKEx, will not incur any liability (whether based on contract, tort, (including, without limitation, negligence), or any other legal or equitable grounds and without regard to the circumstances giving rise to any purported claim except in the case of wilful misconduct on the part of the stock exchange and/or HKEx) for, any direct, consequential, special, indirect, economic, punitive, exemplary or any other loss or damage suffered or incurred by us or any other party arising from or in connection with the mandatory call event or the suspension of trading ("**Trading Suspension**") or the non-recognition of trades after a mandatory call event ("**Non-Recognition of Post MCE Trades**"), including without limitation, any delay, failure, mistake or error in the Trading Suspension or Non-Recognition of Post MCE Trades.

We and our affiliates shall not have any responsibility for any losses suffered as a result of the Trading Suspension and/or Non-Recognition of Post MCE Trades in connection with the occurrence of a mandatory call event, notwithstanding that such Trading Suspension or Non-Recognition of Post MCE Trades may have occurred as a result of an error in the observation of the event.

(35) Fluctuation in the funding cost

The issue price of the CBBCs is set by reference to the difference between the initial reference spot price of the underlying share or unit and the strike price or the initial reference spot level of the index and the strike level (as the case may be), plus the applicable funding cost as of the relevant launch date. The initial funding cost applicable to the CBBCs as set out in the relevant supplemental listing document will fluctuate throughout the life of the CBBCs as the funding rate may change from time to time. The funding rate is a rate determined by us based on one or more of the following factors, including but not limited to the strike price or the strike level (as the case may be), the prevailing interest rate, the expected life of the CBBCs, any expected notional dividends in respect of the underlying shares or any securities comprising the index (as the case may be) and the margin financing provided by us.

(36) Our hedging activities

Our trading and/or hedging activities or those of our related parties related to the CBBCs and/or other financial instruments issued by us from time to time may have an impact on the price or level of the underlying and may trigger a mandatory call event.

In particular, when the price or level of the underlying is close to the call price or call level (as defined in the relevant terms and conditions), our unwinding activities in relation to the underlying may cause a fall or rise (as the case may be) in the price or level of the underlying leading to a mandatory call event as a result of such unwinding activities.

We or our related party may unwind our hedging transactions relating to the CBBCs in proportion to the amount of the CBBCs we repurchase from the market from time to time. Such activity may lead to greater volatility of the price or level of the underlying, and may lead to a mandatory call event as a result. Upon the occurrence of a mandatory call event, we or our related party may unwind any hedging transactions relating to the CBBCs. Such unwinding activities after the occurrence of a mandatory call event may affect the price or level of the underlying and consequently the residual value (if any) for the CBBCs.

The relevant terms and conditions will, together with the supplemental provisions contained in the relevant supplemental listing document and subject to completion and amendment, be endorsed on the global certificate. The applicable supplemental listing document in relation to the issue of any series of structured products may specify additional terms and conditions which shall, to the extent so specified or to the extent inconsistent with the relevant terms and conditions, replace or modify the relevant terms and conditions for the purpose of such series of structured products. Capitalised terms used in the relevant terms and conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE EQUITY WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. The call/put Warrants (the "**Warrants**") (which expression shall, unless the context otherwise requires, include any further Warrants issued pursuant to Condition 13) relating to the Shares of the Company are issued in registered form subject to and with the benefit of a global certificate by way of deed poll (the "**Global Certificate**") dated the Issue Date, made by The Hongkong and Shanghai Banking Corporation Limited (the "**Issuer**") and an instrument by way of deed poll dated 2 April 2012 executed by the Issuer (the "**Instrument**"). Copies of the Global Certificate and the Instrument are available for inspection at the specified office of the Issuer. The Warrantholders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of all the provisions of the Global Certificate and the Instrument.

(b) *Status*. The Warrants represent general, unsecured, contractual obligations of the Issuer and of no other person and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations of the Issuer.

(c) *Transfer*. Transfers of beneficial interests in the Warrants may be effected only in Board Lots or integral multiples thereof in CCASS (as defined below) in accordance with the CCASS Rules (as defined below).

(d) *Title*. Each person who is for the time being shown in the register kept by the Issuer as entitled to a particular number of Warrants shall be treated by the Issuer as the absolute owner and holder of such number of Warrants. The expression "**Warrantholder**" shall be construed accordingly.

2. Warrant Rights and Exercise Expenses

(a) *Warrant Rights*. Every Board Lot gives each Warrantholder, upon due exercise and compliance with Condition 4, the right to receive the payment of the Cash Settlement Amount (as defined below), if any, less any Exercise Expenses (as defined below).

(b) *Exercise Expenses*. On exercise of the Warrants, Warrantholders are required to pay Exercise Expenses. To effect such payment, an irrevocable authorisation to deduct all Exercise Expenses from the applicable Cash Settlement Amount is deemed to be given by a Warrantholder to the Issuer upon purchase of the Warrants. Any Exercise Expenses which have not been determined on the Expiry Date (as defined below) shall be notified to the Warrantholder as soon as practicable after determination thereof by the Issuer and shall be paid by the Warrantholder immediately upon demand.

(c) *Definitions*. For the purposes of these Conditions:

"**Average Price**" means the arithmetic mean of the closing prices of a Share (as derived from the Daily Quotation Sheet of the Stock Exchange, subject to any adjustments to such closing prices as may be necessary to reflect any capitalisation, rights issue, distribution or the like) for each Valuation Date (as defined below);

"**Board Lot**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Business Day**" means a day (excluding Saturdays) on which the Stock Exchange (as defined below) is scheduled to open for dealings in Hong Kong and banks are open for business in Hong Kong;

"**Cash Settlement Amount**" means in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

(1) in the case of a series of call Warrants:

$$\text{Cash Settlement Amount per Board Lot} = \frac{\text{Entitlement x (Average Price – Exercise Price) x one Board Lot}}{\text{Number of Warrants per Entitlement}}$$

(2) in the case of a series of put Warrants:

$$\text{Cash Settlement Amount per Board Lot} = \frac{\text{Entitlement x (Exercise Price – Average Price) x one Board Lot}}{\text{Number of Warrants per Entitlement}}$$

provided that if the Cash Settlement Amount is a negative amount it shall be deemed to be zero;

"**CCASS**" means the Central Clearing and Settlement System established and operated by Hong Kong Securities Clearing Company Limited ("**HKSCC**");

"**CCASS Rules**" means the General Rules of CCASS and the CCASS Operational Procedures in effect from time to time;

"**CCASS Settlement Day**" has the meaning ascribed to the term "Settlement Day" in the General Rules of CCASS, subject to such modification and amendment prescribed by HKSCC from time to time;

"**Company**" means the company specified as such in the relevant Supplemental Listing Document;

"**Entitlement**" means the number specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Exercise Expenses**" means any charges or expenses including any taxes or duties which are incurred or withheld in respect of the exercise of the Warrants;

"**Exercise Price**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Expiry Date**" means the date specified as such in the relevant Supplemental Listing Document;

"**Market Disruption Event**" means:

(1) the occurrence or existence on any Valuation Date during the one-half hour period that ends at the close of trading of any suspension of or limitation imposed on

trading (by reason of movements in price exceeding limits permitted by the Stock Exchange or otherwise) on the Stock Exchange in (i) the Shares; or (ii) any options or futures contracts relating to the Shares if, in any such case, such suspension or limitation is, in the determination of the Issuer, material;

(2) the issuance of the tropical cyclone warning signal number 8 or above or a "BLACK" rainstorm signal on any day which either (i) results in the Stock Exchange being closed for trading for the entire day; or (ii) results in the Stock Exchange being closed prior to its regular time for close of trading for the relevant day (for the avoidance of doubt, in the case when the Stock Exchange is scheduled to open for the morning trading session only, closed prior to its regular time for close of trading for the morning session), PROVIDED THAT there shall be no Market Disruption Event solely by reason of the Stock Exchange opening for trading later than its regular time for opening of trading on any day as a result of the tropical cyclone warning signal number 8 or above or the "BLACK" rainstorm signal having been issued; or

(3) a limitation or closure of the Stock Exchange due to any unforeseen circumstances;

"**Settlement Currency**" has the meaning given to it in the relevant Supplement Listing Document;

"**Settlement Date**" means the third CCASS Settlement Day after the later of: (i) the Expiry Date; and (ii) the day on which the Average Price is determined in accordance with the Conditions;

"**Settlement Disruption Event**" means an event beyond the control of the Issuer as a result of which the Issuer is unable to procure payment electronically through CCASS to the relevant bank account designated by the relevant Warrantholder ("**Designated Bank Account**");

"**Shares**" means the shares of the Company specified as such in the relevant Supplemental Listing Document;

"**Stock Exchange**" means The Stock Exchange of Hong Kong Limited; and

"**Valuation Date**" means, with respect to the exercise of Warrants, and subject as provided below in relation to a Market Disruption Event, each of the five Business Days immediately preceding the Expiry Date.

3. Exercise of Warrants, Automatic Exercise and Expiry

(a) *Exercise of Warrants*. The Warrants are exercisable only on the Expiry Date.

(b) *Automatic Exercise*. Any Warrant will automatically be exercised if the Cash Settlement Amount on the Expiry Date is greater than zero (without notice being given to the Warrantholders). The Warrantholders will not be required to deliver any exercise notice and the Issuer or its agent will pay to the Warrantholders the Cash Settlement Amount (if any) less any Exercise Expenses in accordance with Condition 4(d).

(c) *Expiry*. Any Warrant which has not been automatically exercised in accordance with Condition 3(b) shall expire immediately without value thereafter and all rights of the Warrantholder and obligations of the Issuer with respect to such Warrant shall cease.

4. Exercise of Warrants

(a) Warrants may only be exercised in a Board Lot or integral multiples thereof.

(b) *No requirement to deliver an exercise notice*. The Warrantholders will not be required to deliver an exercise notice for any purpose in relation to the Warrants.

(c) *Cancellation*. The Issuer will, with effect from the first Business Day following the Expiry Date, remove from its register the name of the person in respect of the Warrants which (i) are the subject of an exercise pursuant to automatic exercise in accordance with these Conditions; or (ii) have expired worthless, and thereby cancel the relevant Warrants.

(d) *Cash Settlement*. Subject to automatic exercise of Warrants in accordance with these Conditions, the Issuer will make a payment, in respect of every Board Lot, to the relevant Warrantholder equal to the Cash Settlement Amount less any Exercise Expenses. If the Cash Settlement Amount is equal to, or less than, the determined Exercise Expenses, no Cash Settlement Amount shall be payable by the Issuer.

The Cash Settlement Amount less the determined Exercise Expenses shall be despatched no later than the Settlement Date by crediting that amount in accordance with the CCASS Rules, to the Designated Bank Account.

If as a result of a Settlement Disruption Event, it is not possible for the Issuer to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the Warrantholder on the original Settlement Date, the Issuer shall use its reasonable endeavours to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the Warrantholder as soon as reasonably practicable after the original Settlement Date. The Issuer will not be liable to the Warrantholder for any interest in respect of the amount due or any loss or damage that such Warrantholder may suffer as a result of the existence of the Settlement Disruption Event.

If the Issuer determines, in its sole discretion (acting in good faith and in a commercially reasonable manner), that a Market Disruption Event has occurred on any Valuation Date, then that Valuation Date shall be postponed until the first succeeding Business Day on which there is no Market Disruption Event, irrespective of whether that postponed Valuation Date would fall on a Business Day that is already or is deemed to be a Valuation Date. For the avoidance of doubt, in the event that a Market Disruption Event has occurred and a Valuation Date is postponed as aforesaid, the closing price of the Shares on the first succeeding Business Day will be used more than once in determining the Average Price, so that in no event shall there be less than five closing prices used to determine the Average Price. If the postponement of the Valuation Date as aforesaid would result in the Valuation Date falling on or after the Expiry Date, then: (i) the Business Day immediately preceding the Expiry Date (the "**Last Valuation Date**") shall be deemed to be the Valuation Date notwithstanding the Market Disruption Event; and (ii) the Issuer shall determine the closing price of the Shares on the basis of its good faith estimate of the price that would have prevailed on the Last Valuation Date but for the Market Disruption Event.

5. Register

The Issuer will at all times maintain or arrange for the maintenance of a register in Hong Kong.

6. Adjustments

(a) *Rights Issues*. If and whenever the Company shall, by way of Rights (as defined below), offer new Shares for subscription at a fixed subscription price to the holders of existing Shares pro rata to existing holdings (a "**Rights Offer**"), the Entitlement will be adjusted to take effect on the Business Day on which trading in the Shares of the Company becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{1 + M}{1 + (R/S) \times M}$$

E : Existing Entitlement immediately prior to the Rights Offer

S : Cum-Rights Share price being the closing price of the Shares on the Stock Exchange on the last Business Day on which the Shares are traded on a cum-Rights basis

R : Subscription price per new Share as specified in the Rights Offer plus an amount equal to any dividends or other benefits foregone to exercise the Right

M : Number of new Share(s) (whether a whole or a fraction) per existing Share each holder thereof is entitled to subscribe

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Exercise Price in accordance with the following formula:

$$\begin{array}{c}\text{Adjusted Exercise Price} \\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Exercise Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

For the purposes of these Conditions:

"**Rights**" means the right(s) attached to each existing Share or needed to acquire one new Share (as the case may be) which are given to the holders of existing Shares to subscribe at a fixed subscription price for new Shares pursuant to the Rights Offer (whether by the exercise of one Right, a part of a Right or an aggregate number of Rights).

(b) *Bonus Issues*. If and whenever the Company shall make an issue of Shares credited as fully paid to the holders of Shares generally by way of capitalisation of profits or reserves (other than pursuant to a scrip dividend or similar scheme for the time being operated by the Company or otherwise in lieu of a cash dividend and without any payment or other consideration being made or given by such holders) (a "**Bonus Issue**") the Entitlement will be increased on the Business Day on which trading in the Shares of the Company becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = (1 + N)$$

E : Existing Entitlement immediately prior to the Bonus Issue

N : Number of additional Shares (whether a whole or a fraction) received by a holder of existing Shares for each Share held prior to the Bonus Issue

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Exercise Price in accordance with the following formula:

$$\begin{array}{c}\text{Adjusted Exercise Price}\\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Exercise Price x } \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

(c) *Share Splits or Consolidations*. If and whenever the Company shall subdivide its Shares or any class of its outstanding share capital comprised of the Shares into a greater number of shares (a "**Subdivision**") or consolidate the Shares or any class of its outstanding share capital comprised of the Shares into a smaller number of shares (a "**Consolidation**"), the Entitlement in effect immediately prior thereto will be increased (in the case of a Subdivision) or decreased (in the case of a Consolidation) accordingly in each case on the day on which the relevant Subdivision or Consolidation shall have taken effect. In addition, the Exercise Price (which shall be rounded to the nearest 0.001) will be decreased (in the case of a Subdivision) or increased (in the case of a Consolidation) accordingly.

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

(d) *Merger or Consolidation*. If it is announced that the Company is to or may merge or consolidate with or into any other corporation (including becoming, by agreement or otherwise, a subsidiary of any corporation or controlled by any person or corporation) (except where the Company is the surviving corporation in a merger) or that it is to or may sell or transfer all or substantially all of its assets, the rights attaching to the Warrants may in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner) be amended no later than the Business Day preceding the consummation of such merger, consolidation, sale or transfer (each a "**Restructuring Event**") (as determined by the Issuer in its absolute discretion (acting in good faith and in a commercially reasonable manner)).

The rights attaching to the Warrants after the adjustment shall, after such Restructuring Event, relate to the number of shares of the corporation(s) resulting from or surviving such Restructuring Event or other securities ("**Substituted Securities**") and/or cash offered in substitution for the affected Shares, as the case may be, to which the holder of such number of Shares to which the Warrants related immediately before such Restructuring Event would have been entitled upon such Restructuring Event. Thereafter the provisions hereof shall apply to such Substituted Securities, provided that any Substituted Securities may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be deemed to be replaced by an amount in the relevant currency equal to the market value or, if no market value is available, fair value, of such Substituted Securities in each case as determined by the Issuer as soon as practicable after such Restructuring Event is effected.

For the avoidance of doubt, any remaining Shares shall not be affected by this paragraph (d) and, where cash is offered in substitution for Shares or is deemed to replace Substituted Securities as described above, references in these Conditions to the Shares shall include any such cash.

(e) *Cash Distributions*. Generally, no adjustment will be made for an ordinary cash dividend (whether or not it is offered with a scrip alternative). For any other forms of cash distribution (each a "**Cash Distribution**") announced by the Company, such as a cash bonus, special dividend or extraordinary dividend, no adjustment will be made unless the value of the Cash Distribution accounts for two per cent. or more of the Share's closing price on the day of announcement by the Company.

If and whenever the Company shall make a Cash Distribution credited as fully paid to the holders of Shares generally, the Entitlement will be adjusted to take effect on the Business Day on which trading in the Shares of the Company becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{X - B}{X - B - C}$$

provided that B shall be deducted from X only if the Business Day on which trading in the Shares of the Company becomes ex-entitlement with respect to the Cash Distribution and the distribution of the ordinary cash dividend by the Company falls on the same date.

B: Amount of the relevant ordinary cash dividend per Share

C: Amount of the relevant Cash Distribution per Share

E: Existing Entitlement immediately prior to the Cash Distribution

X: Cum-Cash Distribution Share price being the closing price of the Shares on the Stock Exchange on the last Business Day on which the Shares of the Company are traded on a cum-Cash Distribution basis

In addition, the Issuer shall adjust the Exercise Price in accordance with the following formula:

$$\begin{array}{c}\text{Adjusted Exercise Price} \\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Exercise Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

(f) *Other Adjustments*. Without prejudice to and notwithstanding any prior adjustment(s) made pursuant to the applicable Conditions, the Issuer may (but shall not be obliged to) make such other adjustments to the terms and conditions of the Warrants as appropriate where any event (including the events as contemplated in the applicable

Conditions) occurs and irrespective of, in substitution for, or in addition to the provisions contemplated in the applicable Conditions, provided that such adjustment is:

(i) not materially prejudicial to the interests of the Warrantholders generally (without considering the circumstances of any individual Warrantholder or the tax or other consequences of such adjustment in any particular jurisdiction); or

(ii) determined by the Issuer in good faith to be appropriate and commercially reasonable.

(g) *Notice of Adjustments*. All determinations made by the Issuer pursuant hereto will be conclusive and binding on the Warrantholders. The Issuer will give, or procure that there is given, notice as soon as practicable of any adjustment and of the date from which such adjustment is effective by publication in accordance with Condition 11.

7. Illegality or Impracticability

The Issuer is entitled to terminate the Warrants if it determines in good faith and in a commercially reasonable manner that, for reasons beyond its control, it has become or it will become illegal or impracticable:

(a) for it to perform its obligations under the Warrants, in whole or in part, as a result of: (i) the adoption of, any change in, any relevant law or regulation (including any tax law); or (ii) the promulgation of, or any change in the interpretation by any court, tribunal, governmental, administrative, legislative, regulatory or judicial authority or power with competent jurisdiction of any relevant law or regulation (including any tax law), (each of (i) and (ii), a "**Change in Law Event**"); or

(b) for it or any of its affiliates to maintain the Issuer's hedging arrangements with respect to the Warrants due to a Change in Law Event.

Upon the occurrence of a Change in Law Event, the Issuer will, if and to the extent permitted by applicable law or regulation, pay to each Warrantholder a cash amount that Issuer determines in good faith and in a commercially reasonable manner to be the fair market value in respect of each Warrant held by such Warrantholder immediately prior to such termination (ignoring such illegality or impracticability) less the cost to the Issuer of unwinding any related hedging arrangement and any charges or expenses including any taxes or duties which are incurred or withheld as determined by the Issuer in its sole and absolute discretion (acting in good faith and in a commercially reasonable manner). Payment will be made in such manner as shall be notified to the Warrantholders in accordance with Condition 11.

8. Purchases

The Issuer and/or any of its subsidiaries and affiliates may at any time purchase Warrants at any price in the open market or by tender or by private treaty. Any Warrants so purchased may be held or resold or surrendered for cancellation.

9. Global Certificate

The Warrants are represented by the Global Certificate registered in the name of HKSCC Nominees Limited and deposited with CCASS in accordance with the CCASS Rules. Warrantholders will not be entitled to definitive certificates in respect of any Warrants issued or transferred to them.

10. Meetings of Warrantholders; Modification

(a) *Meetings of Warrantholders*. The Instrument contains provisions for convening meetings of the Warrantholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution (as defined in the Instrument) of a modification of the provisions of the Warrants or of the Global Certificate.

Any resolution to be passed in a meeting of the Warrantholders shall be decided by poll. Such a meeting may be convened by the Issuer or by Warrantholders holding not less than 10 per cent. of the Warrants for the time being remaining unexercised. The quorum at any such meeting for passing an Extraordinary Resolution will be two or more persons holding or representing not less than 25 per cent. of the Warrants for the time being remaining unexercised, or at any adjourned meeting two or more persons being or representing Warrantholders whatever the number of Warrants so held or represented.

A resolution will be an Extraordinary Resolution when it has been passed at a duly convened meeting by not less than three-quarters of the votes cast by such Warrantholders who, being entitled to do so, vote in person or by proxy.

An Extraordinary Resolution passed at any meeting of the Warrantholders shall be binding on all the Warrantholders, whether or not they are present at the meeting.

Resolutions can be passed in writing without a meeting of the Warrantholders being held if passed unanimously.

(b) *Modification*. The Issuer may, without the consent of the Warrantholders, effect any modification of the terms and conditions of the Warrants or the Global Certificate which, in the opinion of the Issuer, is:

(i) not materially prejudicial to the interests of the Warrantholders generally (without considering the circumstances of any individual Warrantholder or the tax or other consequences of such modification in any particular jurisdiction);

(ii) of a formal, minor or technical nature;

(iii) made to correct a manifest error; or

(iv) necessary in order to comply with mandatory provisions of the laws or regulations of Hong Kong.

Any such modification shall be binding on the Warrantholders and shall be notified to them by the Issuer as soon as practicable in accordance with Condition 11.

11. Notices

All notices to Warrantholders will be validly given if published in English and in Chinese on the website of Hong Kong Exchanges and Clearing Limited. Such notices shall be deemed to have been given on the date of the first such publication. If publication is not practicable, notice will be given in such other manner as the Issuer may determine.

12. Liquidation

In the event of a liquidation or dissolution of the Company or the appointment of a liquidator, receiver or administrator or analogous person under applicable law in respect of the whole or substantially the whole of its undertaking, property or assets, all unexercised Warrants will lapse and shall cease to be valid for any purpose, in the case of voluntary liquidation, on the effective date of the relevant resolution and, in the case of an involuntary liquidation or dissolution, on the date of the relevant court order or, in the case of the appointment of a liquidator or receiver or administrator or analogous person under any applicable law in respect of the whole or substantially the whole of its undertaking, property or assets, on the date when such appointment is effective but subject (in any such case) to any contrary mandatory requirement of law.

13. Further Issues

The Issuer shall be at liberty from time to time, without the consent of the Warrantholders, to create and issue further Warrants so as to form a single series with the Warrants.

14. Delisting

(a) If at any time the Shares cease to be listed on the Stock Exchange, the Issuer shall give effect to these Conditions in such manner and make such adjustments to the rights attaching to the Warrants as it shall, in its absolute discretion (acting in good faith and in a commercially reasonable manner), consider appropriate to ensure, so far as it is reasonably able to do so, that the interests of the Warrantholders generally are not materially prejudiced as a consequence of such delisting (without considering the individual circumstances of any Warrantholder or the tax or other consequences that may result in any particular jurisdiction).

(b) Without prejudice to the generality of Condition 14(a), where the Shares are, or, upon the delisting, become, listed on any other stock exchange, these Conditions may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be amended to the extent necessary to allow for the substitution of that other stock exchange in place of the Stock Exchange and the Issuer may, without the consent of the Warrantholders, make such adjustments to the entitlements of Warrantholders on exercise (including, if appropriate, by converting foreign currency amounts at prevailing market rates into the relevant currency) as may be appropriate in the circumstances.

(c) The Issuer shall determine, in its absolute discretion (acting in good faith and in a commercially reasonable manner), any adjustment or amendment and its determination shall be conclusive and binding on the Warrantholders save in the case of manifest error. Notice of any adjustments or amendments shall be given to the Warrantholders in accordance with Condition 11 as soon as practicable after they are determined.

15. Governing Law

The Warrants, the Global Certificate and the Instrument will be governed by and construed in accordance with the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**"). The Issuer and each Warrantholder (by its purchase of the Warrants) shall be deemed to have submitted for all purposes in connection with the Warrants, the Global Certificate and the Instrument to the non-exclusive jurisdiction of the courts of Hong Kong.

16. Language

In the event of any inconsistency between the Chinese translation of these Conditions and the English version of these Conditions, the English version of these Conditions shall prevail.

The relevant terms and conditions will, together with the supplemental provisions contained in the relevant supplemental listing document and subject to completion and amendment, be endorsed on the global certificate. The applicable supplemental listing document in relation to the issue of any series of structured products may specify additional terms and conditions which shall, to the extent so specified or to the extent inconsistent with the relevant terms and conditions, replace or modify the relevant terms and conditions for the purpose of such series of structured products. Capitalised terms used in the relevant terms and conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE INDEX WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. The call/put Warrants (the "**Warrants**") (which expression shall, unless the context otherwise requires, include any further Warrants issued pursuant to Condition 12) relating to the Index as published by the Index Compiler are issued in registered form subject to and with the benefit of a global certificate by way of deed poll (the "**Global Certificate**") dated the Issue Date, made by The Hongkong and Shanghai Banking Corporation Limited (the "**Issue**r") and an instrument by way of deed poll dated 2 April 2012 executed by the Issuer (the "**Instrument**"). Copies of the Global Certificate and the Instrument are available for inspection at the specified office of the Issuer. The Warrantholders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of all the provisions of the Global Certificate and the Instrument.

(b) *Status*. The Warrants represent general, unsecured, contractual obligations of the Issuer and of no other person and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations of the Issuer.

(c) *Transfer*. Transfers of beneficial interests in the Warrants may be effected only in Board Lots or integral multiples thereof in CCASS (as defined below) in accordance with the CCASS Rules (as defined below).

(d) *Title*. Each person who is for the time being shown in the register kept by the Issuer as entitled to a particular number of Warrants shall be treated by the Issuer as the absolute owner and holder of such number of Warrants. The expression "**Warrantholder**" shall be construed accordingly.

2. Warrant Rights and Exercise Expenses

(a) *Warrant Rights*. Every Board Lot entitles each Warrantholder, upon due exercise and compliance with Condition 4, to payment of the Cash Settlement Amount (as defined below), if any, less any Exercise Expenses (as defined below).

(b) *Exercise Expenses*. On exercise of the Warrants, Warrantholders are required to pay Exercise Expenses. To effect such payment, an irrevocable authorisation to deduct all Exercise Expenses from the applicable Cash Settlement Amount is deemed to be given by a Warrantholder to the Issuer upon purchase of the Warrants. Any Exercise Expenses which have not been determined on the Expiry Date shall be notified to the Warrantholder as soon as practicable after determination thereof by the Issuer and shall be paid by the Warrantholder immediately upon demand.

(c) *Definitions*. For the purposes of these Conditions:

"**Board Lot**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Business Day**" means a day (excluding Saturdays) on which the Stock Exchange (as defined below) is scheduled to open for dealings in Hong Kong and banks are open for business in Hong Kong;

"**Cash Settlement Amount**" means in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer equal to:

(1) in the case of a series of call Warrants:

$$\text{Cash Settlement Amount per Board Lot} = \frac{(\text{Closing Level} - \text{Strike Level}) \text{ x one Board Lot x Index Currency Amount}}{\text{Divisor}}$$

(2) in the case of a series of put Warrants:

$$\text{Cash Settlement Amount per Board Lot} = \frac{(\text{Strike Level} - \text{Closing Level}) \text{ x one Board Lot x Index Currency Amount}}{\text{Divisor}}$$

provided that if the Cash Settlement Amount is a negative amount it shall be deemed to be zero;

"**CCASS**" means the Central Clearing and Settlement System established and operated by Hong Kong Securities Clearing Company Limited ("**HKSCC**");

"**CCASS Rules**" means the General Rules of CCASS and the CCASS Operational Procedures in effect from time to time;

"**CCASS Settlement Day**" has the meaning ascribed to the term "Settlement Day" in the General Rules of CCASS, subject to such modification and amendment prescribed by HKSCC from time to time;

"**Closing Level**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Divisor**" means the number specified as such in the relevant Supplemental Listing Document;

"**Exchange Rate**" means the rate specified in the relevant Supplemental Listing Document (if applicable);

"**Exercise Expenses**" means any charges or expenses including any taxes or duties which are incurred or withheld in respect of the exercise of the Warrants;

"**Expiry Date**" means the date specified as such in the relevant Supplemental Listing Document;

"**Index**" means the index specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Index Compiler**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Index Currency Amount**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Index Exchange**" means the exchange specified as such in the relevant Supplemental Listing Document;

"**Market Disruption Event**" means:

(1) the occurrence or existence, on the Valuation Date during the one-half hour period that ends at the close of trading on the Index Exchange, of any of:

(i) the suspension or material limitation of the trading of a material number of securities that comprise the Index; or

(ii) the suspension or material limitation of the trading of options or futures contracts relating to the Index on any exchanges on which such contracts are traded; or

(iii) the imposition of any exchange controls in respect of any currencies involved in determing the Cash Settlement Amount;

for the purposes of paragraph (1), (x) the limitation of the number of hours or days of trading will not constitute a Market Disruption Event if it results from an announced change in the regular business hours of any relevant exchange, and (y) a limitation on trading imposed by reason of the movements in price exceeding the levels permitted by any relevant exchange will constitute a Market Disruption Event; or

(2) where the Index Exchange is the Stock Exchange, the issuance of the tropical cyclone warning signal number 8 or above or a "BLACK" rainstorm signal on any day which either (i) results in the Stock Exchange being closed for trading for the entire day; or (ii) results in the Stock Exchange being closed prior to its regular time for close of trading for the relevant day (for the avoidance of doubt, in the case when the Stock Exchange is scheduled to open for the morning trading session only, closed prior to its regular time for close of trading for the morning session), PROVIDED THAT there shall be no Market Disruption Event solely by reason of the Stock Exchange opening for trading later than its regular time for opening of trading on any day as a result of the tropical cyclone warning signal number 8 or above or the "BLACK" rainstorm signal having been issued; or

(3) a limitation or closure of the Index Exchange due to any unforeseen circumstances; or

(4) any circumstances beyond the control of the Issuer in which the Closing Level or, if applicable, the Exchange Rate cannot be determined by the Issuer in the manner set out in these Conditions or in such other manner as the Issuer considers appropriate at such time after taking into account all the relevant circumstances;

"**Settlement Currency**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Settlement Date**" means the third CCASS Settlement Day after the later of: (i) the Expiry Date; and (ii) the day on which the Closing Level is determined in accordance with the Conditions;

"**Settlement Disruption Event**" means an event beyond the control of the Issuer as a result of which the Issuer is unable to procure payment electronically through CCASS to the relevant bank account designated by the relevant Warrantholder ("**Designated Bank Account**");

"**Stock Exchange**" means The Stock Exchange of Hong Kong Limited;

"**Strike Level**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6; and

"**Valuation Date**" means the date specified as such in the relevant Supplemental Listing Document.

3. Exercise of Warrants, Automatic Exercise and Expiry

(a) *Exercise of Warrants*. The Warrants are exercisable only on the Expiry Date.

(b) *Automatic Exercise*. Any Warrant will automatically be exercised if the Cash Settlement Amount on the Expiry Date is greater than zero (without notice being given to the Warrantholders). The Warrantholders will not be required to deliver any exercise notice and the Issuer or its agent will pay to the Warrantholders the Cash Settlement Amount (if any) less any Exercise Expenses in accordance with Condition 4(d).

(c) *Expiry*. Any Warrant which has not been automatically exercised in accordance with Condition 3(b) shall expire immediately without value thereafter and all rights of the Warrantholder and obligations of the Issuer with respect to such Warrant shall cease.

4. Exercise of Warrants

(a) Warrants may only be exercised in a Board Lot or integral multiples thereof.

(b) *No requirement to deliver an exercise notice*. The Warrantholders will not be required to deliver an exercise notice for any purpose in relation to the Warrants.

(c) *Cancellation*. The Issuer will, with effect from the first Business Day following the Expiry Date, remove from its register the name of the person in respect of the Warrants which (i) are the subject of an exercise pursuant to automatic exercise in accordance with these Conditions or (ii) have expired worthless, and thereby cancel the relevant Warrants.

(d) *Cash Settlement*. Subject to automatic exercise of Warrants in accordance with these Conditions, the Issuer will make a payment, in respect of every Board Lot, to the relevant Warrantholder equal to the Cash Settlement Amount less any Exercise Expenses. If the Cash Settlement Amount is equal to, or less than, the determined Exercise Expenses, no Cash Settlement Amount shall be payable by the Issuer.

The Cash Settlement Amount less the determined Exercise Expenses shall be despatched no later than the Settlement Date by crediting that amount in accordance with the CCASS Rules, to the Designated Bank Account.

If as a result of a Settlement Disruption Event, it is not possible for the Issuer to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the Warrantholder on the original Settlement Date, the Issuer shall use its reasonable endeavours to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the Warrantholder as soon as reasonably practicable after the original Settlement Date. The Issuer will not be liable to the Warrantholder for any interest in respect of the amount due or any loss or damage that such Warrantholder may suffer as a result of the existence of the Settlement Disruption Event.

If the Issuer determines, in its sole discretion (acting in good faith and in a commercially reasonable manner), that on the Valuation Date a Market Disruption Event has occurred, then the Issuer shall determine the Closing Level or, if applicable, the Exchange Rate on the basis of its good faith estimate of the Closing Level or, if applicable, the Exchange Rate that would have prevailed on that day but for the occurrence of the Market Disruption Event provided that in the case of determining the Closing Level, the Issuer, if applicable, may, but shall not be obliged to, determine such Closing Level by having regard to the manner in which futures contracts relating to the Index are calculated.

5. Register

The Issuer will at all times maintain or arrange for the maintenance of a register in Hong Kong.

6. Adjustments to the Index

(a) *Successor Index Compiler Calculates and Reports Index.* If the Index is (i) not calculated and announced by the Index Compiler but is calculated and published by a successor to the Index Compiler (the "**Successor Index Compiler**") acceptable to the Issuer or (ii) replaced by a successor index using, in the determination of the Issuer, the same or a substantially similar formula for and method of calculation as used in the calculation of the Index, then the Index will be deemed to be the index so calculated and announced by the Successor Index Compiler or that successor index, as the case may be.

(b) *Modification and Cessation of Calculation of Index.*

If:

(i) on or prior to a Valuation Date the Index Compiler or (if applicable) the Successor Index Compiler makes a material change in the formula for or the method of calculating the Index or in any other way materially modifies the Index (other than a modification prescribed in that formula or method to maintain the Index in the event of changes in constituent stock, contracts or commodities and other routine events); or

(ii) on a Valuation Date the Index Compiler or (if applicable) the Successor Index Compiler fails to calculate and publish the Index (other than as a result of a Market Disruption Event),

then the Issuer shall determine the Closing Level using, in lieu of a published level for the Index, the level for the Index as at that Valuation Date as determined by the Issuer in accordance with the formula for and method of calculating the Index last in effect prior to that change or failure, but using only those securities, contracts or commodities that comprised the Index immediately prior to that change or failure.

(c) *Other Adjustments*. Without prejudice to and notwithstanding any prior adjustment(s) made pursuant to the applicable Condition, the Issuer may (but shall not be obliged to) make such other adjustments to the terms and conditions of the Warrants as appropriate where any event (including the events as contemplated in the applicable Conditions) occurs and irrespective of, in substitution for, or in addition to the provisions contemplated in the applicable Conditions, provided that such adjustment is:

(i) not materially prejudicial to the interests of the Warrantholders generally (without considering the circumstances of any individual Warrantholder or the tax or other consequences of such adjustment in any particular jurisdiction); or

(ii) determined by the Issuer in good faith to be appropriate and commercially reasonable.

(d) *Notice of Adjustments*. All determinations made by the Issuer pursuant hereto will be conclusive and binding on the Warrantholders. The Issuer will give, or procure that there is given, notice as soon as practicable of any determinations by publication in accordance with Condition 11.

7. Illegality or Impracticability

The Issuer is entitled to terminate the Warrants if it determines in good faith and in a commercially reasonable manner that, for reasons beyond its control, it has become or it will become illegal or impracticable:

(a) for it to perform its obligations under the Warrants, in whole or in part, as a result of: (i) the adoption of, any change in, any relevant law or regulation (including any tax law); or (ii) the promulgation of, or any change in the interpretation by any court, tribunal, governmental, administrative, legislative, regulatory or judicial authority or power with competent jurisdiction of any relevant law or regulation (including any tax law), (each of (i) and (ii), a "**Change in Law Event**"); or

(b) for it or any of its affiliates to maintain the Issuer's hedging arrangements with respect to the Warrants due to a Change in Law Event.

Upon the occurrence of a Change in Law Event, the Issuer will, if and to the extent permitted by applicable law or regulation, pay to each Warrantholder a cash amount that Issuer determines in good faith and in a commercially reasonable manner to be the fair market value in respect of each Warrant held by such Warrantholder immediately prior to such termination (ignoring such illegality or impracticability) less the cost to the Issuer of unwinding any related hedging arrangement and any charges or expenses including any taxes or duties which are incurred or withheld as determined by the Issuer in its sole and absolute discretion (acting in good faith and in a commercially reasonable manner). Payment will be made in such manner as shall be notified to the Warrantholders in accordance with Condition 11.

8. Purchases

The Issuer and/or any of its subsidiaries and affiliates may at any time purchase Warrants at any price in the open market or by tender or by private treaty. Any Warrants so purchased may be held or resold or surrendered for cancellation.

9. Global Certificate

The Warrants are represented by the Global Certificate registered in the name of HKSCC Nominees Limited and deposited with CCASS in accordance with the CCASS Rules. Warrantholders will not be entitled to definitive certificates in respect of any Warrants issued or transferred to them.

10. Meetings of Warrantholders; Modification

(a) *Meetings of Warrantholders*. The Instrument contains provisions for convening meetings of the Warrantholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution (as defined in the Instrument) of a modification of the provisions of the Warrants or of the Global Certificate.

Any resolution to be passed in a meeting of the Warrantholders shall be decided by poll. Such a meeting may be convened by the Issuer or by Warrantholders holding not less than 10 per cent. of the Warrants for the time being remaining unexercised. The quorum at any such meeting for passing an Extraordinary Resolution will be two or more persons holding or representing not less than 25 per cent. of the Warrants for the time being remaining unexercised, or at any adjourned meeting two or more persons being or representing Warrantholders whatever the number of Warrants so held or represented.

A resolution will be an Extraordinary Resolution when it has been passed at a duly convened meeting by not less than three-quarters of the votes cast by such Warrantholders who, being entitled to do so, vote in person or by proxy.

An Extraordinary Resolution passed at any meeting of the Warrantholders shall be binding on all the Warrantholders, whether or not they are present at the meeting.

Resolutions can be passed in writing without a meeting of the Warrantholders being held if passed unanimously.

(b) *Modification*. The Issuer may, without the consent of the Warrantholders, effect any modification of the terms and conditions of the Warrants or the Global Certificate which, in the opinion of the Issuer, is:

(i) not materially prejudicial to the interests of the Warrantholders generally (without considering the circumstances of any individual Warrantholder or the tax or other consequences of such modification in any particular jurisdiction);

(ii) of a formal, minor or technical nature;

(iii) made to correct a manifest error; or

(iv) necessary in order to comply with mandatory provisions of the laws or regulations of Hong Kong.

Any such modification shall be binding on the Warrantholders and shall be notified to them by the Issuer as soon as practicable in accordance with Condition 11.

11. Notices

All notices to Warrantholders will be validly given if published in English and in Chinese on the website of Hong Kong Exchanges and Clearing Limited. Such notices shall be deemed to have been given on the date of the first such publication. If publication is not practicable, notice will be given in such other manner as the Issuer may determine.

12. Further Issues

The Issuer shall be at liberty from time to time, without the consent of the Warrantholders, to create and issue further Warrants so as to form a single series with the Warrants.

13. Governing Law

The Warrants, the Global Certificate and the Instrument will be governed by and construed in accordance with the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**"). The Issuer and each Warrantholder (by its purchase of the Warrants) shall be deemed to have submitted for all purposes in connection with the Warrants, the Global Certificate and the Instrument to the non-exclusive jurisdiction of the courts of Hong Kong.

14. Language

In the event of any inconsistency between the Chinese translation of these Conditions and the English version of these Conditions, the English version of these Conditions shall prevail.

The relevant terms and conditions will, together with the supplemental provisions contained in the relevant supplemental listing document and subject to completion and amendment, be endorsed on the global certificate. The applicable supplemental listing document in relation to the issue of any series of structured products may specify additional terms and conditions which shall, to the extent so specified or to the extent inconsistent with the relevant terms and conditions, replace or modify the relevant terms and conditions for the purpose of such series of structured products. Capitalised terms used in the relevant terms and conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE UNIT FUND WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. The call/put Warrants (the "**Warrants**") (which expression shall, unless the context otherwise requires, include any further Warrants issued pursuant to Condition 13) relating to the Units of the Fund are issued in registered form subject to and with the benefit of a global certificate by way of deed poll (the "**Global Certificate**") dated the Issue Date, made by The Hongkong and Shanghai Banking Corporation Limited (the "**Issuer**") and an instrument by way of deed poll dated 2 April 2012 executed by the Issuer (the "**Instrument**"). Copies of the Global Certificate and the Instrument are available for inspection at the specified office of the Issuer. The Warrantholders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of all the provisions of the Global Certificate and the Instrument.

(b) *Status*. The Warrants represent general, unsecured, contractual obligations of the Issuer and of no other person and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations of the Issuer.

(c) *Transfer*. Transfers of beneficial interests in the Warrants may be effected only in Board Lots or integral multiples thereof in CCASS (as defined below) in accordance with the CCASS Rules (as defined below).

(d) *Title*. Each person who is for the time being shown in the register kept by the Issuer as entitled to a particular number of Warrants shall be treated by the Issuer as the absolute owner and holder of such number of Warrants. The expression "**Warrantholder**" shall be construed accordingly.

2. Warrant Rights and Exercise Expenses

(a) *Warrant Rights*. Every Board Lot gives each Warrantholder, upon due exercise and compliance with Condition 4, the right to receive the payment of the Cash Settlement Amount (as defined below), if any, less any Exercise Expenses (as defined below).

(b) *Exercise Expenses*. On exercise of the Warrants, Warrantholders are required to pay Exercise Expenses. To effect such payment, an irrevocable authorisation to deduct all Exercise Expenses from the applicable Cash Settlement Amount is deemed to be given by a Warrantholder to the Issuer upon purchase of the Warrants. Any Exercise Expenses which have not been determined on the Expiry Date (as defined below) shall be notified to the Warrantholder as soon as practicable after determination thereof by the Issuer and shall be paid by the Warrantholder immediately upon demand.

(c) *Definitions*. For the purposes of these Conditions:

"**Average Price**" means the arithmetic mean of the closing prices of a Unit (as derived from the Daily Quotation Sheet of the Stock Exchange, subject to any adjustments to such closing prices as may be necessary to reflect any capitalisation, rights issue, distribution or the like) for each Valuation Date (as defined below);

"**Board Lot**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Business Day**" means a day (excluding Saturdays) on which the Stock Exchange (as defined below) is scheduled to open for dealings in Hong Kong and banks are open for business in Hong Kong;

"**Cash Settlement Amount**" means in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

(1) in the case of a series of call Warrants:

$$\text{Cash Settlement Amount per Board Lot} = \frac{\text{Entitlement x (Average Price – Exercise Price) x one Board Lot}}{\text{Number of Warrants per Entitlement}}$$

(2) in the case of a series of put Warrants:

$$\text{Cash Settlement Amount per Board Lot} = \frac{\text{Entitlement x (Exercise Price – Average Price) x one Board Lot}}{\text{Number of Warrants per Entitlement}}$$

provided that if the Cash Settlement Amount is a negative amount it shall be deemed to be zero;

"**CCASS**" means the Central Clearing and Settlement System established and operated by Hong Kong Securities Clearing Company Limited ("**HKSCC**");

"**CCASS Rules**" means the General Rules of CCASS and the CCASS Operational Procedures in effect from time to time;

"**CCASS Settlement Day**" has the meaning ascribed to the term "Settlement Day" in the General Rules of CCASS, subject to such modification and amendment prescribed by HKSCC from time to time;

"**Entitlement**" means the number specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Exercise Expenses**" means any charges or expenses including any taxes or duties which are incurred or withheld in respect of the exercise of the Warrants;

"**Exercise Price**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Expiry Date**" means the date specified as such in the relevant Supplemental Listing Document;

"**Fund**" means the fund specified as such in the relevant Supplemental Listing Document;

"**Market Disruption Event**" means:

(1) the occurrence or existence on any Valuation Date during the one-half hour period that ends at the close of trading of any suspension of or limitation imposed on trading (by reason of movements in price exceeding limits permitted by the Stock Exchange or otherwise) on the Stock Exchange in (i) the Units; or (ii) any options or futures contracts relating to the Units if, in any such case, such suspension or limitation is, in the determination of the Issuer, material;

(2) the issuance of the tropical cyclone warning signal number 8 or above or a "BLACK" rainstorm signal on any day which either (i) results in the Stock Exchange being closed for trading for the entire day; or (ii) results in the Stock Exchange being closed prior to its regular time for close of trading for the relevant day (for the avoidance of doubt, in the case when the Stock Exchange is scheduled to open for the morning trading session only, closed prior to its regular time for close of trading for the morning session), PROVIDED THAT there shall be no Market Disruption Event solely by reason of the Stock Exchange opening for trading later than its regular time for opening of trading on any day as a result of the tropical cyclone warning signal number 8 or above or the "BLACK" rainstorm signal having been issued; or

(3) a limitation or closure of the Stock Exchange due to any unforeseen circumstances;

"**Settlement Currency**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Settlement Date**" means the third CCASS Settlement Day after the later of: (i) the Expiry Date; and (ii) the day on which the Average Price is determined in accordance with the Conditions;

"**Settlement Disruption Event**" means an event beyond the control of the Issuer as a result of which the Issuer is unable to procure payment electronically through CCASS to the relevant bank account designated by the relevant Warrantholder ("**Designated Bank Account**");

"**Stock Exchange**" means The Stock Exchange of Hong Kong Limited;

"**Units**" means the units of the Fund specified as such in the relevant Supplemental Listing Document; and

"**Valuation Date**" means, with respect to the exercise of Warrants, and subject as provided below in relation to a Market Disruption Event, each of the five Business Days immediately preceding the Expiry Date.

3. Exercise of Warrants, Automatic Exercise and Expiry

(a) *Exercise of Warrants*. The Warrants are exercisable only on the Expiry Date.

(b) *Automatic Exercise*. Any Warrant will automatically be exercised if the Cash Settlement Amount on the Expiry Date is greater than zero (without notice being given to the Warrantholders). The Warrantholders will not be required to deliver any exercise notice and the Issuer or its agent will pay to the Warrantholders the Cash Settlement Amount (if any) less any Exercise Expenses in accordance with Condition 4(d).

(c) *Expiry*. Any Warrant which has not been automatically exercised in accordance with Condition 3(b) shall expire immediately without value thereafter and all rights of the Warrantholder and obligations of the Issuer with respect to such Warrant shall cease.

4. Exercise of Warrants

(a) Warrants may only be exercised in a Board Lot or integral multiples thereof.

(b) *No requirement to deliver an exercise notice*. The Warrantholders will not be required to deliver an exercise notice for any purpose in relation to the Warrants.

(c) *Cancellation*. The Issuer will, with effect from the first Business Day following the Expiry Date, remove from its register the name of the person in respect of the Warrants which (i) are the subject of an exercise pursuant to automatic exercise in accordance with these Conditions; or (ii) have expired worthless, and thereby cancel the relevant Warrants.

(d) *Cash Settlement*. Subject to automatic exercise of Warrants in accordance with these Conditions, the Issuer will make a payment, in respect of every Board Lot, to the relevant Warrantholder equal to the Cash Settlement Amount less any Exercise Expenses. If the Cash Settlement Amount is equal to, or less than, the determined Exercise Expenses, no Cash Settlement Amount shall be payable by the Issuer.

The Cash Settlement Amount less the determined Exercise Expenses shall be despatched no later than the Settlement Date by crediting that amount in accordance with the CCASS Rules, to the Designated Bank Account.

If as a result of a Settlement Disruption Event, it is not possible for the Issuer to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the Warrantholder on the original Settlement Date, the Issuer shall use its reasonable endeavours to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the Warrantholder as soon as reasonably practicable after the original Settlement Date. The Issuer will not be liable to the Warrantholder for any interest in respect of the amount due or any loss or damage that such Warrantholder may suffer as a result of the existence of the Settlement Disruption Event.

If the Issuer determines, in its sole discretion (acting in good faith and in a commercially reasonable manner), that a Market Disruption Event has occurred on any Valuation Date, then that Valuation Date shall be postponed until the first succeeding Business Day on which there is no Market Disruption Event, irrespective of whether that postponed Valuation Date would fall on a Business Day that is already or is deemed to be a Valuation Date. For the avoidance of doubt, in the event that a Market Disruption Event has occurred and a Valuation Date is postponed as aforesaid, the closing price of the Units on the first succeeding Business Day will be used more than once in determining the Average Price, so that in no event shall there be less than five closing prices used to determine the Average Price. If the postponement of the Valuation Date as aforesaid would result in the Valuation Date falling on or after the Expiry Date, then: (i) the Business Day immediately preceding the Expiry Date (the "**Last Valuation Date**") shall be deemed to be the Valuation Date notwithstanding the Market Disruption Event; and (ii) the Issuer shall determine the closing price of the Units on the basis of its good faith estimate of the price that would have prevailed on the Last Valuation Date but for the Market Disruption Event.

5. Register

The Issuer will at all times maintain or arrange for the maintenance of a register in Hong Kong.

6. Adjustments

(a) *Rights Issues*. If and whenever the Fund shall, by way of Rights (as defined below), offer new Units for subscription at a fixed subscription price to the holders of existing Units pro rata to existing holdings (a "**Rights Offer**"), the Entitlement will be adjusted to take effect on the Business Day on which trading in the Units of the Fund becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{1 + M}{1 + (R/S) \times M}$$

E : Existing Entitlement immediately prior to the Rights Offer

S : Cum-Rights Unit price being the closing price of the Units on the Stock Exchange on the last Business Day on which the Units are traded on a cum-Rights basis

R : Subscription price per new Unit as specified in the Rights Offer plus an amount equal to any distributions or other benefits foregone to exercise the Right

M : Number of new Unit(s) (whether a whole or a fraction) per existing Unit each holder thereof is entitled to subscribe

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Exercise Price in accordance with the following formula:

$$\begin{array}{c}\text{Adjusted Exercise Price} \\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Exercise Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

For the purposes of these Conditions:

"**Rights**" means the right(s) attached to each existing Unit or needed to acquire one new Unit (as the case may be) which are given to the holders of existing Units to subscribe at a fixed subscription price for new Units pursuant to the Rights Offer (whether by the exercise of one Right, a part of a Right or an aggregate number of Rights).

(b) *Bonus Issues*. If and whenever the Fund shall make an issue of Units credited as fully paid to the holders of Units generally (other than pursuant to a scrip distribution or similar scheme for the time being operated by the Fund or otherwise in lieu of a cash distribution and without any payment or other consideration being made or given by such holders) (a "**Bonus Issue**") the Entitlement will be increased on the Business Day on which trading in the Units of the Fund becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

Adjustment Component = (1 + N)

E : Existing Entitlement immediately prior to the Bonus Issue

N : Number of additional Units (whether a whole or a fraction) received by a holder of existing Units for each Unit held prior to the Bonus Issue

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Exercise Price in accordance with the following formula:

$$\text{Adjusted Exercise Price (rounded to the nearest 0.001)} = \text{Exercise Price x } \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

(c) *Unit Splits or Consolidations*. If and whenever the Fund shall subdivide its Units or any class of its outstanding units into a greater number of units (a "**Subdivision**") or consolidate the Units or any class of its outstanding units into a smaller number of units (a "**Consolidation**"), the Entitlement in effect immediately prior thereto will be increased (in the case of a Subdivision) or decreased (in the case of a Consolidation) accordingly in each case on the day on which the relevant Subdivision or Consolidation shall have taken effect. In addition, the Exercise Price (which shall be rounded to the nearest 0.001) will be decreased (in the case of a Subdivision) or increased (in the case of a Consolidation) accordingly.

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

(d) *Merger or Consolidation*. If it is announced that the Fund is to or may merge with or into any other fund or consolidate with or into any other fund or corporation (including becoming, by agreement or otherwise, controlled by any person or corporation) (except where the Fund is the surviving entity in a merger) or that it is to or may sell or transfer all or substantially all of its assets, the rights attaching to the Warrants may in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner) be amended no later than the Business Day preceding the consummation of such merger, consolidation, sale or transfer (each a "**Restructuring Event**") (as determined by the Issuer in its absolute discretion (acting in good faith and in a commercially reasonable manner)).

The rights attaching to the Warrants after the adjustment shall, after such Restructuring Event, relate to the number of units of the fund(s) resulting from or surviving such Restructuring Event or other securities ("**Substituted Securities**") and/or cash offered in substitution for the affected Units, as the case may be, to which the holder of such number of Units to which the Warrants related immediately before such Restructuring Event would have been entitled upon such Restructuring Event. Thereafter the provisions hereof shall apply to such Substituted Securities, provided that any Substituted Securities may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be deemed to be replaced by an amount in the relevant currency equal to the market value or, if no market value is available, fair value, of such Substituted Securities in each case as determined by the Issuer as soon as practicable after such Restructuring Event is effected.

For the avoidance of doubt, any remaining Units shall not be affected by this paragraph (d) and, where cash is offered in substitution for Units or is deemed to replace Substituted Securities as described above, references in these Conditions to the Units shall include any such cash.

(e) *Cash Distributions*. Generally, no adjustment will be made for an ordinary cash distribution (whether or not it is offered with a scrip alternative). For any other forms of cash distribution (each a "**Cash Distribution**") announced by the Fund, such as a cash bonus, special dividend or extraordinary dividend, no adjustment will be made unless the value of the Cash Distribution accounts for two per cent. or more of the Unit's closing price on the day of announcement by the Fund.

If and whenever the Fund shall make a Cash Distribution credited as fully paid to the holders of Units generally, the Entitlement will be adjusted to take effect on the Business Day on which trading in the Units of the Fund becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{X - B}{X - B - C}$$

provided that B shall be deducted from X only if the Business Day on which trading in the Units of the Fund becomes ex-entitlement with respect to the Cash Distribution and the distribution of the ordinary cash distribution by the Fund falls on the same date.

B: Amount of the relevant ordinary cash distribution per Unit

C: Amount of the relevant Cash Distribution per Unit

E: Existing Entitlement immediately prior to the Cash Distribution

X: Cum-Cash Distribution Unit price being the closing price of the Units on the Stock Exchange on the last Business Day on which the Units of the Fund are traded on a cum-Cash Distribution basis

In addition, the Issuer shall adjust the Exercise Price in accordance with the following formula:

$$\begin{array}{c}\text{Adjusted Exercise Price}\\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Exercise Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Exercise Price shall take effect on the same day that the Entitlement is adjusted.

(f) *Other Adjustments*. Without prejudice to and notwithstanding any prior adjustment(s) made pursuant to the applicable Conditions, the Issuer may (but shall not be obliged to) make such other adjustments to the terms and conditions of the Warrants as appropriate where any event (including the events as contemplated in the applicable

Conditions) occurs and irrespective of, in substitution for, or in addition to the provisions contemplated in the applicable Conditions, provided that such adjustment is:

(i) not materially prejudicial to the interests of the Warrantholders generally (without considering the circumstances of any individual Warrantholder or the tax or other consequences of such adjustment in any particular jurisdiction); or

(ii) determined by the Issuer in good faith to be appropriate and commercially reasonable.

(g) *Notice of Adjustments*. All determinations made by the Issuer pursuant hereto will be conclusive and binding on the Warrantholders. The Issuer will give, or procure that there is given, notice as soon as practicable of any adjustment and of the date from which such adjustment is effective by publication in accordance with Condition 11.

7. Illegality or Impracticability

The Issuer is entitled to terminate the Warrants if it determines in good faith and in a commercially reasonable manner that, for reasons beyond its control, it has become or it will become illegal or impracticable:

(a) for it to perform its obligations under the Warrants, in whole or in part, as a result of: (i) the adoption of, any change in, any relevant law or regulation (including any tax law); or (ii) the promulgation of, or any change in the interpretation by any court, tribunal, governmental, administrative, legislative, regulatory or judicial authority or power with competent jurisdiction of any relevant law or regulation (including any tax law), (each of (i) and (ii), a "**Change in Law Event**"); or

(b) for it or any of its affiliates to maintain the Issuer's hedging arrangements with respect to the Warrants due to a Change in Law Event.

Upon the occurrence of a Change in Law Event, the Issuer will, if and to the extent permitted by applicable law or regulation, pay to each Warrantholder a cash amount that Issuer determines in good faith and in a commercially reasonable manner to be the fair market value in respect of each Warrant held by such Warrantholder immediately prior to such termination (ignoring such illegality or impracticability) less the cost to the Issuer of unwinding any related hedging arrangement and any charges or expenses including any taxes or duties which are incurred or withheld as determined by the Issuer in its sole and absolute discretion (acting in good faith and in a commercially reasonable manner). Payment will be made in such manner as shall be notified to the Warrantholders in accordance with Condition 11.

8. Purchases

The Issuer and/or any of its subsidiaries and affiliates may at any time purchase Warrants at any price in the open market or by tender or by private treaty. Any Warrants so purchased may be held or resold or surrendered for cancellation.

9. Global Certificate

The Warrants are represented by the Global Certificate registered in the name of HKSCC Nominees Limited and deposited with CCASS in accordance with the CCASS Rules. Warrantholders will not be entitled to definitive certificates in respect of any Warrants issued or transferred to them.

10. Meetings of Warrantholders; Modification

(a) *Meetings of Warrantholders*. The Instrument contains provisions for convening meetings of the Warrantholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution (as defined in the Instrument) of a modification of the provisions of the Warrants or of the Global Certificate.

Any resolution to be passed in a meeting of the Warrantholders shall be decided by poll. Such a meeting may be convened by the Issuer or by Warrantholders holding not less than 10 per cent. of the Warrants for the time being remaining unexercised. The quorum at any such meeting for passing an Extraordinary Resolution will be two or more persons holding or representing not less than 25 per cent. of the Warrants for the time being remaining unexercised, or at any adjourned meeting two or more persons being or representing Warrantholders whatever the number of Warrants so held or represented.

A resolution will be an Extraordinary Resolution when it has been passed at a duly convened meeting by not less than three-quarters of the votes cast by such Warrantholders who, being entitled to do so, vote in person or by proxy.

An Extraordinary Resolution passed at any meeting of the Warrantholders shall be binding on all the Warrantholders, whether or not they are present at the meeting.

Resolutions can be passed in writing without a meeting of the Warrantholders being held if passed unanimously.

(b) *Modification*. The Issuer may, without the consent of the Warrantholders, effect any modification of the terms and conditions of the Warrants or the Global Certificate which, in the opinion of the Issuer, is:

(i) not materially prejudicial to the interests of the Warrantholders generally (without considering the circumstances of any individual Warrantholder or the tax or other consequences of such modification in any particular jurisdiction);

(ii) of a formal, minor or technical nature;

(iii) made to correct a manifest error; or

(iv) necessary in order to comply with mandatory provisions of the laws or regulations of Hong Kong.

Any such modification shall be binding on the Warrantholders and shall be notified to them by the Issuer as soon as practicable in accordance with Condition 11.

11. Notices

All notices to Warrantholders will be validly given if published in English and in Chinese on the website of Hong Kong Exchanges and Clearing Limited. Such notices shall be deemed to have been given on the date of the first such publication. If publication is not practicable, notice will be given in such other manner as the Issuer may determine.

12. Liquidation

In the event of (i) a liquidation, dissolution or termination of the Fund or (ii) the appointment of a liquidator, receiver or administrator or analogous person under applicable law in respect of the whole or substantially the whole of its undertaking, property or assets or (iii) the withdrawal of the Securities and Futures Commission's authorisation of the Fund under the Securities and Futures Ordinance, all unexercised Warrants will lapse and shall cease to be valid for any purpose, in the case of (i) voluntary liquidation, on the effective date of the relevant resolution, (ii) an involuntary liquidation or dissolution, on the date of the relevant court order, (iii) a termination, on the effective date of the termination, (iv) the appointment of a liquidator or receiver or administrator or analogous person under any applicable law in respect of the whole or substantially the whole of its undertaking, property or assets, on the date on which such appointment is effective, or (v) withdrawal of authorisation, on the date on which such withdrawal becomes effective, but subject (in any such case) to any contrary mandatory requirement of law.

13. Further Issues

The Issuer shall be at liberty from time to time, without the consent of the Warrantholders, to create and issue further Warrants so as to form a single series with the Warrants.

14. Delisting

(a) If at any time the Units cease to be listed on the Stock Exchange, the Issuer shall give effect to these Conditions in such manner and make such adjustments to the rights attaching to the Warrants as it shall, in its absolute discretion (acting in good faith and in a commercially reasonable manner), consider appropriate to ensure, so far as it is reasonably able to do so, that the interests of the Warrantholders generally are not materially prejudiced as a consequence of such delisting (without considering the individual circumstances of any Warrantholder or the tax or other consequences that may result in any particular jurisdiction).

(b) Without prejudice to the generality of Condition 14(a), where the Units are, or, upon the delisting, become, listed on any other stock exchange, these Conditions may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be amended to the extent necessary to allow for the substitution of that other stock exchange in place of the Stock Exchange and the Issuer may, without the consent of the Warrantholders, make such adjustments to the entitlements of Warrantholders on exercise (including, if appropriate, by converting foreign currency amounts at prevailing market rates into the relevant currency) as may be appropriate in the circumstances.

(c) The Issuer shall determine, in its absolute discretion (acting in good faith and in a commercially reasonable manner), any adjustment or amendment and its determination shall be conclusive and binding on the Warrantholders save in the case of manifest error. Notice of any adjustments or amendments shall be given to the Warrantholders in accordance with Condition 11 as soon as practicable after they are determined.

15. Governing Law

The Warrants, the Global Certificate and the Instrument will be governed by and construed in accordance with the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**"). The Issuer and each Warrantholder (by its purchase of the Warrants) shall be deemed to have submitted for all purposes in connection with the Warrants, the Global Certificate and the Instrument to the non-exclusive jurisdiction of the courts of Hong Kong.

16. Language

In the event of any inconsistency between the Chinese translation of these Conditions and the English version of these Conditions, the English version of these Conditions shall prevail.

The relevant terms and conditions will, together with the supplemental provisions contained in the relevant supplemental listing document and subject to completion and amendment, be endorsed on the global certificate. The applicable supplemental listing document in relation to the issue of any series of structured products may specify additional terms and conditions which shall, to the extent so specified or to the extent inconsistent with the relevant terms and conditions, replace or modify the relevant terms and conditions for the purpose of such series of structured products. Capitalised terms used in the relevant terms and conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE EQUITY CALLABLE BULL/BEAR CONTRACTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. The Callable Bull/Bear Contracts (the "**CBBCs**") (which expression shall, unless the context otherwise requires, include any further CBBCs issued pursuant to Condition 13) relating to the Shares of the Company are issued in registered form subject to and with the benefit of a global certificate by way of deed poll (the "**Global Certificate**") dated the Issue Date, made by The Hongkong and Shanghai Banking Corporation Limited (the "**Issuer**") and an instrument by way of deed poll dated 2 April 2012 executed by the Issuer (the "**Instrument**"). Copies of the Global Certificate and the Instrument are available for inspection at the specified office of the Issuer. The CBBC Holders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of all the provisions of the Global Certificate and the Instrument.

(b) *Status*. The CBBCs represent general, unsecured, contractual obligations of the Issuer and of no other person and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations of the Issuer.

(c) *Transfer*. Transfers of beneficial interests in the CBBCs may be effected only in Board Lots or integral multiples thereof in CCASS (as defined below) in accordance with the CCASS Rules (as defined below).

(d) *Title*. Each person who is for the time being shown in the register kept by the Issuer as entitled to a particular number of CBBCs shall be treated by the Issuer as the absolute owner and holder of such number of CBBCs. The expression "**CBBC Holder**" shall be construed accordingly.

2. CBBC Rights and Exercise Expenses

(a) *CBBC Rights*. Every Board Lot gives each CBBC Holder, (i) upon due exercise and compliance with Condition 4, the right to receive the payment of the Cash Settlement Amount, (if any) less any Exercise Expenses or (ii) upon compliance with Condition 4, the right to receive the payment of the Residual Value, (if any) less any Exercise Expenses following the occurrence of a Mandatory Call Event (all as defined below).

(b) *Exercise Expenses*. On expiry of the CBBCs or upon the occurrence of a Mandatory Call Event, CBBC Holders are required to pay the Exercise Expenses. To effect such payment, an irrevocable authorisation to deduct the Exercise Expenses from the applicable Cash Settlement Amount or the Residual Value (as the case may be) is deemed to be given by a CBBC Holder to the Issuer upon purchase of the CBBCs. Any Exercise Expenses which have not been determined on the Expiry Date or following the Mandatory Call Event shall be notified to the CBBC Holder as soon as practicable after determination thereof by the Issuer and shall be paid by the CBBC Holder immediately upon demand.

(c) *Definitions*. For the purposes of these Conditions:

"**Board Lot**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Business Day**" means a day (excluding Saturdays) on which the Stock Exchange (as defined below) is scheduled to open for dealings in Hong Kong and banks are open for business in Hong Kong;

"**Call Price**" means the price of the Shares specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Cash Settlement Amount**" means:

(1) in the case of a series of bull CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

$$\begin{array}{c}\text{Cash Settlement Amount}\\ \text{per Board Lot}\end{array} = \frac{\text{Entitlement x (Closing Price – Strike Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

(2) in the case of a series of bear CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

$$\begin{array}{c}\text{Cash Settlement Amount}\\ \text{per Board Lot}\end{array} = \frac{\text{Entitlement x (Strike Price – Closing Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

provided that if the Cash Settlement Amount is a negative amount it shall be deemed to be zero;

"**CCASS**" means the Central Clearing and Settlement System established and operated by Hong Kong Securities Clearing Company Limited ("**HKSCC**");

"**CCASS Rules**" means the General Rules of CCASS and the CCASS Operational Procedures in effect from time to time;

"**CCASS Settlement Day**" has the meaning ascribed to the term "Settlement Day" in the General Rules of CCASS, subject to such modification and amendment prescribed by HKSCC from time to time;

"**Closing Price**" means the official closing price of one Share (as derived from the Daily Quotation Sheet of the Stock Exchange, subject to any adjustments to such closing price as may be necessary to reflect any capitalisation, rights issue, distribution or the like) on the Valuation Date (as defined below);

"**Company**" means the company specified as such in the relevant Supplemental Listing Document;

"**Entitlement**" means the number specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Exercise Expenses**" means any charges or expenses including any taxes or duties which are incurred or withheld in respect of the expiry of the CBBCs or the occurrence of a Mandatory Call Event (as the case may be);

"**Expiry Date**" means the date specified as such in the relevant Supplemental Listing Document;

"**IEP**" means the indicative equilibrium price, as determined in accordance with the Rules and Regulations of the Stock Exchange prescribed by the Stock Exchange from time to time (the "**Trading Rules**");

"**Mandatory Call Event**" occurs:

(1) in the case of a series of bull CBBCs, if the Spot Price is at or below the Call Price at any time during a Trading Day in the Observation Period; and

(2) in the case of a series of bear CBBCs, if the Spot Price is at or above the Call Price at any time during a Trading Day in the Observation Period;

"**Market Disruption Event**" means:

(1) (i) with respect to exercise of the CBBCs, the occurrence or existence on the Valuation Date during the one-half hour period that ends at the close of trading of, or (ii) with respect to the determination of the Residual Value, the occurrence or existence during a trading session resulting in any suspension of or limitation imposed on trading (by reason of movements in price exceeding limits permitted by the Stock Exchange or otherwise) on the Stock Exchange in

 (a) the Shares; and/or

 (b) any options or futures contracts relating to the Shares if, in any such case, that suspension or limitation is, in the determination of the Issuer, material; or

(2) (i) with respect to exercise of the CBBCs, the issuance of the tropical cyclone warning signal number 8 or above or a "BLACK" rainstorm signal which either results in the Stock Exchange being closed for dealings for an entire day or results in the Stock Exchange being closed prior to its regular time for close of trading on any day, provided that there shall be no Market Disruption Event solely by reason of the Stock Exchange opening later than its regular time for open of trading on any day as a result of the tropical cyclone warning signal number 8 or above or the BLACK rainstorm signal having been issued, or (ii) with respect to the determination of the Residual Value and in respect of a trading session, the issuance of the tropical cyclone warning signal number 8 or above or a BLACK rainstorm signal which results in the Stock Exchange being closed for dealings; or

(3) a limitation or closure of the Stock Exchange due to any unforeseen circumstances;

"**Maximum Trade Price**" means the highest Spot Price during the MCE Valuation Period;

"**MCE Valuation Period**" means the period commencing from and including the moment upon which the Mandatory Call Event occurs (the trading session during which the Mandatory Call Event occurs is the "**First Session**") and up to the end of the trading session on the Stock Exchange immediately following the First Session (the "**Second Session**") unless, in the determination of the Issuer in good faith, the Second Session for any reason (including, without limitation, a Market Disruption Event occurring and subsisting in the Second Session) does not contain any continuous period of one hour or more than one hour during which trading in the Shares is permitted on the Stock Exchange with no limitation imposed, in which case the MCE Valuation Period shall be extended to the end of the subsequent trading session following the Second

Session during which trading in the Shares is permitted on the Stock Exchange with no limitation imposed for a continuous period of at least one hour notwithstanding the existence or continuance of a Market Disruption Event in such postponed trading session, unless the Issuer determines in good faith that each trading session on each of the four Trading Days immediately following the date on which the Mandatory Call Event occurs does not contain any continuous period of one hour or more than one hour during which trading in the Shares is permitted on the Stock Exchange with no limitation imposed. In that case:

(i) the period commencing from the First Session up to, and including, the last trading session on the Stock Exchange of the fourth Trading Day immediately following the date on which the Mandatory Call Event occurs shall be deemed to be the MCE Valuation Period; and

(ii) the Issuer shall determine the Maximum Trade Price or the Minimum Trade Price (as the case may be) having regard to the then prevailing market conditions, the last reported Spot Price and such other factors as the Issuer may determine to be relevant in good faith.

For the avoidance of doubt, all Spot Prices available throughout the extended MCE Valuation Period shall be taken into account to determine the Maximum Trade Price or the Minimum Trade Price (as the case may be) for the calculation of the Residual Value.

For the purposes of this definition,

(a) the pre-opening session, the morning session and, in the case of half day trading, the closing auction session (if any) of the same day; and

(b) the afternoon session and the closing auction session (if any) of the same day,

shall each be considered as one trading session only;

"**Minimum Trade Price**" means the lowest Spot Price during the MCE Valuation Period;

"**Observation Commencement Date**" has the meaning specified in the relevant Supplemental Listing Document;

"**Observation Period**" means the period from the Observation Commencement Date to the Trading Day immediately preceding the Expiry Date (both dates inclusive);

"**Post MCE Trades**" means, subject to such modification and amendment prescribed by the Stock Exchange from time to time, (i) if the Mandatory Call Event occurs during a pre-opening session or a closing auction session (if applicable), as the case may be, of the Stock Exchange, all auction trades in the CBBCs concluded in such session and all manual trades concluded after the end of the pre-order matching period in such session; or (ii) if the Mandatory Call Event occurs during a continuous trading session of the Stock Exchange, all trades in the CBBCs concluded via auto-matching or manually after the time of the occurrence of a Mandatory Call Event;

"**Price Determination Date**" means the date on which the Maximum Trade Price or the Minimum Trade Price (as the case may be) is determined by the Issuer;

"**Residual Value**" will be calculated in accordance with the formula specified below by reference to the lowest Spot Price (in respect of a series of bull CBBCs) or the highest Spot Price (in respect of a series of bear CBBCs) of the underlying Shares available during a MCE Valuation Period:

(1) in the case of a series of bull CBBCs and in respect of every Board Lot:

$$\frac{\text{Entitlement x (Minimum Trade Price – Strike Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

(2) in the case of a series of bear CBBCs and in respect of every Board Lot:

$$\frac{\text{Entitlement x (Strike Price – Maximum Trade Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

provided that if the Residual Value is a negative amount it shall be deemed to be zero;

"**Settlement Currency**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Settlement Date**" means the third CCASS Settlement Day after (i) the end of the MCE Valuation Period or (ii) the later of (a) the Expiry Date; and (b) the day on which the Closing Price is determined in accordance with the Conditions (as the case may be);

"**Settlement Disruption Event**" means an event beyond the control of the Issuer as a result of which the Issuer is unable to procure payment electronically through CCASS to the relevant bank account designated by the relevant CBBC Holder ("**Designated Bank Account**");

"**Shares**" means the shares of Company specified as such in the relevant Supplemental Listing Document;

"**Spot Price**" means:

(i) in respect of a continuous trading session of the Stock Exchange, the price per Share concluded by means of automatic order matching on the Stock Exchange as reported in the official real-time dissemination mechanism for the Stock Exchange during such continuous trading session in accordance with the Trading Rules, excluding direct business (as defined in the Trading Rules); and

(ii) in respect of a pre-opening session or a closing auction session (if applicable) of the Stock Exchange (as the case may be), the final IEP of the Share (if any) calculated at the end of the pre-order matching period of such pre-opening session or closing auction session (if applicable) (as the case may be) in accordance with the Trading Rules, excluding direct business (as defined in the Trading Rules),

subject to such modification and amendment prescribed by the Stock Exchange from time to time;

"**Stock Exchange**" means The Stock Exchange of Hong Kong Limited;

"**Strike Price**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Trading Day**" means a day on which the Stock Exchange is scheduled to be open for trading for its regular trading sessions; and

"**Valuation Date**" means the Trading Day immediately preceding the Expiry Date.

3. Exercise of CBBCs, Mandatory Call Event, Automatic Exercise and Expiry

(a) *Exercise of CBBCs*. The CBBCs are exercisable on the Expiry Date, provided that a Mandatory Call Event has not occurred.

(b) *Mandatory Call Event*. Any CBBC in respect of which a Mandatory Call Event has occurred will automatically expire upon the occurrence of a Mandatory Call Event and every Board Lot will entitle the CBBC Holder to receive the Residual Value (if any) less any Exercise Expenses on the Settlement Date (as defined in Condition 4 below).

(c) *Automatic Exercise*. Any CBBC which has not automatically expired will automatically be exercised if, on the Expiry Date, the value of the Cash Settlement Amount is greater than zero (without prior notice being given to the CBBC Holders). The CBBC Holders will not be required to deliver any exercise notice and the Issuer or its agent will pay to the CBBC Holders the Cash Settlement Amount (if any) less any Exercise Expenses in accordance with Condition 4(d).

(d) *Issuer's Obligations*. For the avoidance of doubt, where the CBBCs have been exercised on the Expiry Date or have automatically expired upon the occurrence of a Mandatory Call Event (as the case may be), payment of the Cash Settlement Amount or the Residual Value (if any) (as the case may be) less any Exercise Expenses shall constitute full and final settlement of the obligations of the Issuer with respect to the CBBCs. Subject to such payment having been made, the Issuer shall have no obligation towards the relevant CBBC Holder under the CBBCs subsequent to such Expiry Date or the date on which a Mandatory Call Event occurs (as the case may be).

(e) *Expiry*. Any CBBC which does not automatically expire in accordance with Condition 3(b) or which has not been automatically exercised in accordance with Condition 3(c) (as the case may be) shall expire immediately without value thereafter and all rights of the CBBC Holder and obligations of the Issuer with respect to such CBBC shall cease.

4. Exercise of CBBCs, Cancellation and Payment

(a) *Board Lots*. CBBCs may only be exercised in a Board Lot or integral multiples thereof.

(b) *No requirement to deliver an exercise notice*. The CBBC Holders will not be required to deliver an exercise notice for any purpose in relation to the CBBCs.

(c) *Cancellation*. The Issuer will, with effect from the first Business Day following the date on which a Mandatory Call Event occurs or the Expiry Date (as the case may be), remove from its register the name of the person in respect of the CBBCs which (i) are the subject of an occurrence of a Mandatory Call Event; (ii) are the subject of an exercise pursuant to automatic exercise in accordance with these Conditions; or (iii) have expired worthless, and thereby cancel the relevant CBBCs.

(d) *Cash Settlement*. Subject to automatic exercise of CBBCs or the occurrence of a Mandatory Call Event in accordance with these Conditions, the Issuer will make a payment, in respect of every Board Lot, to the relevant CBBC Holder equal to the Cash Settlement Amount or the Residual Value (if any) (as the case may be) less any Exercise Expenses. If the Cash Settlement Amount or the Residual Value is equal to, or less than, the determined Exercise Expenses, no Cash Settlement Amount or Residual Value shall be payable by the Issuer.

The Cash Settlement Amount or the Residual Value (as the case may be) less determined Exercise Expenses shall be despatched no later than the Settlement Date by crediting that amount in accordance with the CCASS Rules, to the Designated Bank Account.

If as a result of a Settlement Disruption Event, it is not possible for the Issuer to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the CBBC Holder on the original Settlement Date, the Issuer shall use its reasonable endeavours to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the CBBC Holder as soon as reasonably practicable after the original Settlement Date. The Issuer will not be liable to the CBBC Holder for any interest in respect of the amount due or any loss or damage that such CBBC Holder may suffer as a result of the existence of the Settlement Disruption Event, nor shall the Issuer be liable under any circumstances for any acts or defaults of CCASS in relation to the performance of its duties in relation to the CBBCs.

If the Issuer determines, in its sole discretion (acting in good faith and in a commercially reasonable manner), that a Market Disruption Event has occurred on the Valuation Date, then that Valuation Date shall be postponed to the first succeeding Trading Day on which the Issuer determines that there is no Market Disruption Event, unless the Issuer determines that there is a Market Disruption Event on each of the four Trading Days immediately following the original date that, but for the Market Disruption Event, would have been the Valuation Date. In that case:

(i) the fourth Trading Day immediately following the original date shall be deemed to be the Valuation Date, notwithstanding the Market Disruption Event; and

(ii) the Issuer shall determine the closing price of the Shares having regard to the then prevailing market conditions, the last reported Spot Price and such other factors as the Issuer determines to be relevant in good faith.

5. Register

The Issuer will at all times maintain or arrange for the maintenance of a register in Hong Kong.

6. Adjustments

(a) *Rights Issues*. If and whenever the Company shall, by way of Rights (as defined below), offer new Shares for subscription at a fixed subscription price to the holders of existing Shares pro rata to existing holdings (a "**Rights Offer**"), the Entitlement will be adjusted to take effect on the Business Day on which trading in the Shares of the Company becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{1 + M}{1 + (R/S) \times M}$$

E : Existing Entitlement immediately prior to the Rights Offer

S : Cum-Rights Share price being the closing price of the Shares on the Stock Exchange on the last Business Day on which the Shares are traded on a cum-Rights basis

R : Subscription price per new Share as specified in the Rights Offer plus an amount equal to any dividends or other benefits foregone to exercise the Right

M : Number of new Share(s) (whether a whole or a fraction) per existing Share each holder thereof is entitled to subscribe

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Call Price and/or Strike Price in accordance with the following formulas:

$$\text{Adjusted Call Price (rounded to the nearest 0.001)} = \text{Call Price} \times \frac{1}{\text{Adjustment Component}}$$

$$\text{Adjusted Strike Price (rounded to the nearest 0.001)} = \text{Strike Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

For the purposes of these Conditions:

"**Rights**" means the right(s) attached to each existing Share or needed to acquire one new Share (as the case may be) which are given to the holders of existing Shares to subscribe at a fixed subscription price for new Shares pursuant to the Rights Offer (whether by the exercise of one Right, a part of a Right or an aggregate number of Rights).

(b) *Bonus Issues*. If and whenever the Company shall make an issue of Shares credited as fully paid to the holders of Shares generally by way of capitalisation of profits or reserves (other than pursuant to a scrip dividend or similar scheme for the time being operated by the Company or otherwise in lieu of a cash dividend and without any payment or other consideration being made or given by such holders) (a "**Bonus Issue**") the Entitlement will be increased on the Business Day on which trading in the Shares of the Company becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

Adjustment Component = (1 + N)

E : Existing Entitlement immediately prior to the Bonus Issue

N : Number of additional Shares (whether a whole or a fraction) received by a holder of existing Shares for each Share held prior to the Bonus Issue

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Call Price and/or Strike Price in accordance with the following formulas:

$$\text{Adjusted Call Price (rounded to the nearest 0.001)} = \text{Call Price} \times \frac{1}{\text{Adjustment Component}}$$

$$\text{Adjusted Strike Price (rounded to the nearest 0.001)} = \text{Strike Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

(c) *Share Splits or Consolidations*. If and whenever the Company shall subdivide its Shares or any class of its outstanding share capital comprised of the Shares into a greater number of shares (a "**Subdivision**") or consolidate the Shares or any class of its outstanding share capital comprised of the Shares into a smaller number of shares (a "**Consolidation**"), the Entitlement in effect immediately prior thereto will be increased (in the case of a Subdivision) or decreased (in the case of a Consolidation) accordingly in each case on the day on which the relevant Subdivision or Consolidation shall have taken effect. In addition, the Call Price and/or Strike Price (each of which shall be rounded to the nearest 0.001) will be decreased (in the case of a Subdivision) or increased (in the case of a Consolidation) accordingly.

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

(d) *Merger or Consolidation*. If it is announced that the Company is to or may merge or consolidate with or into any other corporation (including becoming, by agreement or otherwise, a subsidiary of any corporation or controlled by any person or corporation) (except where the Company is the surviving corporation in a merger) or that it is to or may sell or transfer all or substantially all of its assets, the rights attaching to the CBBCs may in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner) be amended no later than the Business Day preceding the consummation of such merger, consolidation, sale or transfer (each a "**Restructuring Event**") (as determined by the Issuer in its absolute discretion (acting in good faith and in a commercially reasonable manner)).

The rights attaching to the CBBCs after the adjustment shall, after such Restructuring Event, relate to the number of shares of the corporation(s) resulting from or surviving such Restructuring Event or other securities ("**Substituted Securities**") and/or cash offered in substitution for the affected Shares, as the case may be, to which the holder of such number of Shares to which the CBBCs related immediately before such Restructuring Event would have been entitled upon such Restructuring Event. Thereafter the provisions hereof shall apply to such Substituted Securities, provided that any Substituted Securities may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be deemed to be replaced by an amount in the relevant currency equal to the market value or, if no market value is available, fair value, of such Substituted Securities in each case as determined by the Issuer as soon as practicable after such Restructuring Event is effected.

For the avoidance of doubt, any remaining Shares shall not be affected by this paragraph (d) and, where cash is offered in substitution for Shares or is deemed to replace Substituted Securities as described above, references in these Conditions to the Shares shall include any such cash.

(e) *Cash Distributions*. Generally, no adjustment will be made for an ordinary cash dividend (whether or not it is offered with a scrip alternative). For any other forms of cash distribution (each a "**Cash Distribution**") announced by the Company, such as a cash bonus, special dividend or extraordinary dividend, no adjustment will be made unless the value of the Cash Distribution accounts for two per cent. or more of the Share's closing price on the day of announcement by the Company.

If and whenever the Company shall make a Cash Distribution credited as fully paid to the holders of Shares generally, the Entitlement will be adjusted to take effect on the Business Day on which trading in the Shares of the Company becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{X - B}{X - B - C}$$

provided that B shall be deducted from X only if the Business Day on which trading in the Shares of the Company becomes ex-entitlement with respect to the Cash Distribution and the distribution of the ordinary cash dividend by the Company falls on the same date.

B: Amount of the relevant ordinary cash dividend per Share

C: Amount of the relevant Cash Distribution per Share

E: Existing Entitlement immediately prior to the Cash Distribution

X: Cum-Cash Distribution Share price being the closing price of the Shares on the Stock Exchange on the last Business Day on which the Shares of the Company are traded on a cum-Cash Distribution basis

In addition, the Issuer shall adjust the Call Price and/or Strike Price in accordance with the following formulas:

$$\underset{\text{(rounded to the nearest 0.001)}}{\text{Adjusted Call Price}} = \text{Call Price} \times \frac{1}{\text{Adjustment Component}}$$

$$\underset{\text{(rounded to the nearest 0.001)}}{\text{Adjusted Strike Price}} = \text{Strike Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

(f) *Other Adjustments*. Without prejudice to and notwithstanding any prior adjustment(s) made pursuant to the applicable Condition, the Issuer may (but shall not be obliged to) make such other adjustments to the terms and conditions of the CBBCs as appropriate where any event (including the events as contemplated in the applicable Conditions) occurs and irrespective of, in substitution for, or in addition to the provisions contemplated in the applicable Conditions, provided that such adjustment is:

(i) not materially prejudicial to the interests of the CBBC Holders generally (without considering the circumstances of any individual CBBC Holder or the tax or other consequences of such adjustment in any particular jurisdiction); or

(ii) determined by the Issuer in good faith to be appropriate and commercially reasonable.

For the avoidance of doubt, such adjustments may, but need not, be determined by reference to the adjustment(s) made in respect of such event or events by an options exchange to options on the relevant Shares traded on such options exchange.

(g) *Notice of Adjustments*. All determinations made by the Issuer pursuant hereto will be conclusive and binding on the CBBC Holders. The Issuer will give, or procure that there is given, notice as soon as practicable of any adjustment and of the date from which such adjustment is effective by publication in accordance with Condition 11.

7. Illegality or Impracticability

The Issuer is entitled to terminate the CBBCs if it determines in good faith and in a commercially reasonable manner that, for reasons beyond its control, it has become or it will become illegal or impracticable:

(a) for it to perform its obligations under the CBBCs, in whole or in part, as a result of: (i) the adoption of, any change in, any relevant law or regulation (including any tax law); or (ii) the promulgation of, or any change in the interpretation by any court, tribunal, governmental, administrative, legislative, regulatory or judicial authority or power with competent jurisdiction of any relevant law or regulation (including any tax law), (each of (i) and (ii), a "**Change in Law Event**"); or

(b) for it or any of its affiliates to maintain the Issuer's hedging arrangements with respect to the CBBCs due to a Change in Law Event.

Upon the occurrence of a Change in Law Event, the Issuer will, if and to the extent permitted by applicable law or regulation, pay to each CBBC Holder a cash amount that Issuer determines in good faith and in a commercially reasonable manner to be the fair market value in respect of each CBBC held by such CBBC Holder immediately prior to such termination (ignoring such illegality or impracticability) less the cost to the Issuer of unwinding any related hedging arrangement and any charges or expenses including any taxes or duties which are incurred or withheld as determined by the Issuer in its sole and absolute discretion (acting in good faith and in a commercially reasonable manner). Payment will be made in such manner as shall be notified to the CBBC Holders in accordance with Condition 11.

8. Purchases

The Issuer and/or any of its subsidiaries and affiliates may at any time purchase CBBCs at any price in the open market or by tender or by private treaty. Any CBBCs so purchased may be held or resold or surrendered for cancellation.

9. Global Certificate

The CBBCs are represented by the Global Certificate registered in the name of HKSCC Nominees Limited and deposited with CCASS in accordance with the CCASS Rules. CBBC Holders will not be entitled to definitive certificates in respect of any CBBCs issued or transferred to them.

10. Meetings of CBBC Holders; Modification

(a) *Meetings of CBBC Holders*. The Instrument contains provisions for convening meetings of the CBBC Holders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution (as defined in the Instrument) of a modification of the provisions of the CBBCs or of the Global Certificate.

Any resolution to be passed in a meeting of the CBBC Holders shall be decided by poll. Such a meeting may be convened by the Issuer or by CBBC Holders holding not less than 10 per cent. of the CBBCs for the time being remaining unexercised. The quorum at any such meeting for passing an Extraordinary Resolution will be two or more persons holding or representing not less than 25 per cent. of the CBBCs for the time being remaining unexercised, or at any adjourned meeting two or more persons being or representing CBBC Holders whatever the number of CBBCs so held or represented.

A resolution will be an Extraordinary Resolution when it has been passed at a duly convened meeting by not less than three-quarters of the votes cast by such CBBC Holders who, being entitled to do so, vote in person or by proxy.

An Extraordinary Resolution passed at any meeting of the CBBC Holders shall be binding on all the CBBC Holders, whether or not they are present at the meeting.

Resolutions can be passed in writing without a meeting of the CBBC Holders being held if passed unanimously.

(b) *Modification*. The Issuer may, without the consent of the CBBC Holders, effect any modification of the terms and conditions of the CBBCs or the Global Certificate which, in the opinion of the Issuer, is:

(i) not materially prejudicial to the interests of the CBBC Holders generally (without considering the circumstances of any individual CBBC Holder or the tax or other consequences of such modification in any particular jurisdiction);

(ii) of a formal, minor or technical nature;

(iii) made to correct a manifest error; or

(iv) necessary in order to comply with mandatory provisions of the laws or regulations of Hong Kong.

Any such modification shall be binding on the CBBC Holders and shall be notified to them by the Issuer as soon as practicable in accordance with Condition 11.

11. Notices

All notices to CBBC Holders will be validly given if published in English and in Chinese on the website of Hong Kong Exchanges and Clearing Limited. Such notices shall be deemed to have been given on the date of the first such publication. If publication is not practicable, notice will be given in such other manner as the Issuer may determine.

12. Liquidation

In the event of a liquidation or dissolution of the Company or the appointment of a liquidator, receiver or administrator or analogous person under applicable law in respect of the whole or substantially the whole of its undertaking, property or assets, all unexercised CBBCs will lapse and shall cease to be valid for any purpose, in the case of voluntary liquidation, on the effective date of the relevant resolution and, in the case of an involuntary liquidation or dissolution, on the date of the relevant court order or, in the case of the appointment of a liquidator or receiver or administrator or analogous person under any applicable law in respect of the whole or substantially the whole of its undertaking, property or assets, on the date when such appointment is effective but subject (in any such case) to any contrary mandatory requirement of law.

13. Further Issues

The Issuer shall be at liberty from time to time, without the consent of the CBBC Holders, to create and issue further CBBCs so as to form a single series with the CBBCs.

14. Delisting

(a) If at any time the Shares cease to be listed on the Stock Exchange, the Issuer shall give effect to these Conditions in such manner and make such adjustments to the rights attaching to the CBBCs as it shall, in its absolute discretion (acting in good faith and in a commercially reasonable manner), consider appropriate to ensure, so far as it is reasonably able to do so, that the interests of the CBBC Holders generally are not materially prejudiced as a consequence of such delisting (without considering the individual circumstances of any CBBC Holder or the tax or other consequences that may result in any particular jurisdiction).

(b) Without prejudice to the generality of Condition 14(a), where the Shares are, or, upon the delisting, become, listed on any other stock exchange, these Conditions may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be amended to the extent necessary to allow for the substitution of that other stock exchange in place of the Stock Exchange and the Issuer may, without the consent of the CBBC Holders, make such adjustments to the entitlements of CBBC Holders on exercise (including, if appropriate, by converting foreign currency amounts at prevailing market rates into the relevant currency) as may be appropriate in the circumstances.

(c) The Issuer shall determine, in its absolute discretion (acting in good faith and in a commercially reasonable manner), any adjustment or amendment and its determination shall be conclusive and binding on the CBBC Holders save in the case of manifest error. Notice of any adjustments or amendments shall be given to the CBBC Holders in accordance with Condition 11 as soon as practicable after they are determined.

15. Governing Law

The CBBCs, the Global Certificate and the Instrument will be governed by and construed in accordance with the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**"). The Issuer and each CBBC Holder (by its purchase of the CBBCs) shall be deemed to have submitted for all purposes in connection with the CBBCs, the Global Certificate and the Instrument to the non-exclusive jurisdiction of the courts of Hong Kong.

16. Language

In the event of any inconsistency between the Chinese translation of these Conditions and the English version of these Conditions, the English version of these Conditions shall prevail.

The relevant terms and conditions will, together with the supplemental provisions contained in the relevant supplemental listing document and subject to completion and amendment, be endorsed on the global certificate. The applicable supplemental listing document in relation to the issue of any series of structured products may specify additional terms and conditions which shall, to the extent so specified or to the extent inconsistent with the relevant terms and conditions, replace or modify the relevant terms and conditions for the purpose of such series of structured products. Capitalised terms used in the relevant terms and conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE INDEX CALLABLE BULL/BEAR CONTRACTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. The Callable Bull/Bear Contracts (the "**CBBCs**") (which expression shall, unless the context otherwise requires, include any further CBBCs issued pursuant to Condition 12) relating to the Index as published by the Index Compiler are issued in registered form subject to and with the benefit of a global certificate by way of deed poll (the "**Global Certificate**") dated the Issue Date, made by The Hongkong and Shanghai Banking Corporation Limited (the "**Issuer**") and an instrument by way of deed poll dated 2 April 2012 executed by the Issuer (the "**Instrument**"). Copies of the Global Certificate and the Instrument are available for inspection at the specified office of the Issuer. The CBBC Holders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of all the provisions of the Global Certificate and the Instrument.

(b) *Status*. The CBBCs represent general, unsecured, contractual obligations of the Issuer and of no other person and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations of the Issuer.

(c) *Transfer*. Transfers of beneficial interests in the CBBCs may be effected only in Board Lots or integral multiples thereof in CCASS (as defined below) in accordance with the CCASS Rules (as defined below).

(d) *Title*. Each person who is for the time being shown in the register kept by the Issuer as entitled to a particular number of CBBCs shall be treated by the Issuer as the absolute owner and holder of such number of CBBCs. The expression "**CBBC Holder**" shall be construed accordingly.

2. CBBC Rights and Exercise Expenses

(a) *CBBC* Rights. Every Board Lot entitles each CBBC Holder, (i) upon due exercise and compliance with Condition 4, the right to receive the payment of the Cash Settlement Amount, (if any) less any Exercise Expenses or (ii) upon compliance with Condition 4, the right to receive the payment of the Residual Value, (if any) less any Exercise Expenses following the occurrence of a Mandatory Call Event (all as defined below).

(b) *Exercise Expenses*. On expiry of the CBBCs or upon the occurrence of a Mandatory Call Event, CBBC Holders are required to pay the Exercise Expenses. To effect such payment, an irrevocable authorisation to deduct the Exercise Expenses from the applicable Cash Settlement Amount or the Residual Value (as the case may be) is deemed to be given by a CBBC Holder to the Issuer upon purchase of the CBBCs. Any Exercise Expenses which have not been determined on the Expiry Date or following the Mandatory Call Event shall be notified to the CBBC Holder as soon as practicable after determination thereof by the Issuer and shall be paid by the CBBC Holder immediately upon demand.

(c) *Definitions*. For the purposes of these Conditions:

"**Board Lot**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Business Day**" means a day (excluding Saturdays) on which the Stock Exchange (as defined below) is scheduled to open for dealings in Hong Kong and banks are open for business in Hong Kong;

"**Call Level**" means the level of the Index specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Cash Settlement Amount**" means:

(1) in the case of a series of bull CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer equal to:

$$\text{Cash Settlement Amount per Board Lot} = \frac{(\text{Closing Level} - \text{Strike Level}) \text{ x one Board Lot x Index Currency Amount}}{\text{Divisor}}$$

(2) in the case of a series of bear CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

$$\text{Cash Settlement Amount per Board Lot} = \frac{(\text{Strike Level} - \text{Closing Level}) \text{ x one Board Lot x Index Currency Amount}}{\text{Divisor}}$$

provided that if the Cash Settlement Amount is a negative amount, it shall be deemed to be zero;

"**CCASS**" means the Central Clearing and Settlement System established and operated by Hong Kong Securities Clearing Company Limited ("**HKSCC**");

"**CCASS Rules**" means the General Rules of CCASS and the CCASS Operational Procedures in effect from time to time;

"**CCASS Settlement Day**" has the meaning ascribed to the term "Settlement Day" in the General Rules of CCASS, subject to such modification and amendment prescribed by HKSCC from time to time;

"**Closing Level**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Divisor**" means the number specified as such in the relevant Supplemental Listing Document;

"**Exchange Rate**" means the rate specified in the relevant Supplemental Listing Document (if applicable);

"**Exercise Expenses**" means any charges or expenses including any taxes or duties which are incurred or withheld in respect of the expiry of the CBBCs or the occurrence of a Mandatory Call Event (as the case may be);

"**Expiry Date**" means the date specified as such in the relevant Supplemental Listing Document;

"**IEP**" means the indicative equilibrium price, as determined in accordance with the Rules and Regulations of the Stock Exchange prescribed by the Stock Exchange from time to time;

"**Index**" means the index specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Index Business Day**" means a day on which the Index is scheduled to be published by the Index Compiler or as the case may be, the Successor Index Compiler;

"**Index Compiler**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Index Currency Amount**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Index Exchange**" means the exchange specified as such in the relevant Supplement Listing Document;

"**Mandatory Call Event**" occurs:

(1) in the case of a series of bull CBBCs, if the Spot Level is at or below the Call Level at any time during an Index Business Day in the Observation Period; and

(2) in the case of a series of bear CBBCs, if the Spot Level is at or above the Call Level at any time during an Index Business Day in the Observation Period;

"**Market Disruption Event**" means:

(1) (i) with respect to exercise of the CBBCs, the occurrence or existence, on the Valuation Date during the one-half hour period that ends at the close of trading on the Index Exchange, or (ii) with respect to the determination of the Residual Value, the occurrence or existence during a trading session of any:

    (a) suspension or material limitation of the trading of a material number of securities that comprise the Index; and/or

    (b) suspension or material limitation of the trading of options or futures contracts relating to the Index on any exchanges on which such contracts are traded; and/or

    (c) imposition of any exchange controls in respect of any currencies involved in determing the Cash Settlement Amount or the Residual Value (as the case may be);

    for the purposes of paragraph (1), (x) the limitation of the number of hours or days of trading will not constitute a Market Disruption Event if it results from an announced change in the regular business hours of any exchange, and (y) a limitation on trading imposed by reason of the movements in price exceeding the levels permitted by any relevant exchange will constitute a Market Disruption Event; or

(2) where the Index Exchange is the Stock Exchange, (i) with respect to the exercise of the CBBCs the issuance of the tropical cyclone warning signal number 8 or above or a "BLACK" rainstorm signal which either results in the Stock Exchange being closed for dealings for an entire day or results in the Stock

Exchange being closed prior to its regular time for close of trading on any day, provided that there shall be no Market Disruption Event on the Valuation Date solely by reason of the Stock Exchange opening later than its regular time for open of trading on any day as a result of the tropical cyclone warning signal number 8 or above or the "BLACK" rainstorm signal having been issued, or (ii) with respect to the determination of the Residual Value and in respect of a trading session, the issuance of the tropical cyclone warning signal number 8 or above or a "BLACK" rainstorm signal which results in the Stock Exchange being closed for dealings; or

(3) where the Index Exchange is the Stock Exchange, a limitation or closure of the Stock Exchange due to any unforeseen circumstances; or

(4) any circumstances beyond the control of the Issuer in which the Closing Level or, if applicable, the Exchange Rate cannot be determined by the Issuer in the manner set out in these Conditions or in such other manner as the Issuer considers appropriate at such time after taking into account all the relevant circumstances;

"**Maximum Index Level**" means the highest Spot Level during the MCE Valuation Period;

"**MCE Valuation Period**" means the period commencing from and including the moment upon which the Mandatory Call Event occurs (the trading session during which the Mandatory Call Event occurs is the "**First Session**") and up to the end of the trading session on the Index Exchange immediately following the First Session (the "**Second Session**") unless, in the determination of the Issuer in good faith, the Second Session for any reason (including, without limitation, a Market Disruption Event occurring and subsisting in the Second Session) does not contain any continuous period of one hour or more than one hour during which Spot Levels are available, in which case the MCE Valuation Period shall be extended to the end of the subsequent trading session on the Index Exchange following the Second Session during which Spot Levels are available for a continuous period of at least one hour notwithstanding the existence or continuance of a Market Disruption Event in such postponed trading session, unless the Issuer determines in good faith that each trading session on each of the four Index Business Days immediately following the date on which the Mandatory Call Event occurs does not contain any continuous period of one hour or more than one hour during which Spot Levels are available. In that case:

(i) the period commencing from the First Session up to, and including, the last trading session of the fourth Index Business Day on the Index Exchange immediately following the date on which the Mandatory Call Event occurs shall be deemed to be the MCE Valuation Period; and

(ii) the Issuer shall determine the Maximum Index Level or the Minimum Index Level (as the case may be) having regard to the then prevailing market conditions, the last reported Spot Level of the Index and such other factors as the Issuer may determine to be relevant in good faith.

For the avoidance of doubt, all Spot Levels available throughout the extended MCE Valuation Period shall be taken into account to determine the Maximum Index Level or the Minimum Index Level (as the case may be) for the calculation of the Residual Value.

For the purposes of this definition,

(a) the pre-opening session, the morning session and, in the case of half day trading, the closing auction session (if any) of the same day; and

(b) the afternoon session and the closing auction session (if any) of the same day,

shall each be considered as one trading session only;

"**Minimum Index Level**" means the lowest Spot Level during the MCE Valuation Period;

"**Observation Commencement Date**" has the meaning specified in the relevant Supplemental Listing Document;

"**Observation Period**" means the period from the Observation Commencement Date to the Trading Day immediately preceding the Expiry Date (both dates inclusive);

"**Post MCE Trades**" means, subject to such modification and amendment prescribed by the Stock Exchange from time to time, (i) if the Mandatory Call Event occurs during a pre-opening session or a closing auction session (if applicable), as the case may be, of the Stock Exchange, all auction trades in the CBBC concluded in such session and all manual trades concluded after the end of the pre-order matching period in such session; or (ii) if the Mandatory Call Event occurs during a continuous trading session of the Stock Exchange, all trades of the CBBCs concluded via auto-matching or manually after the time of the occurrence of a Mandatory Call Event;

"**Price Determination Date**" means the date on which the Maximum Index Level or the Minimum Index Level (as the case may be) is determined by the Issuer;

"**Residual Value**" will be calculated in accordance with the formula specified below by reference to the lowest Spot Level (in respect of a series of bull CBBCs) or the highest Spot Level (in respect of a series of bear CBBCs) of the Index available during a MCE Valuation Period:

(1) in the case of a series of bull CBBCs and in respect of every Board Lot:

$$\frac{(\text{Minimum Index Level} - \text{Strike Level}) \times \text{one Board Lot} \times \text{Index Currency Amount}}{\text{Divisor}}$$

(2) in the case of a series of bear CBBCs and in respect of every Board Lot:

$$\frac{(\text{Strike Level} - \text{Maximum Index Level}) \times \text{one Board Lot} \times \text{Index Currency Amount}}{\text{Divisor}}$$

provided that if the Residual Value is a negative amount it shall be deemed to be zero;

"**Settlement Currency**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Settlement Date**" means the third CCASS Settlement Day after (i) the end of the MCE Valuation Period or (ii) the later of (a) the Expiry Date; and (b) the day on which the Closing Level is determined in accordance with the Conditions (as the case may be);

"**Settlement Disruption Event**" means an event beyond the control of the Issuer as a result of which the Issuer is unable to procure payment electronically through CCASS to the relevant bank account designated by the relevant CBBC Holder ("**Designated Bank Account**");

"**Spot Level**" means the spot level of the Index as compiled and published by the Index Compiler;

"**Stock Exchange**" means The Stock Exchange of Hong Kong Limited;

"**Strike Level**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Trading Day**" means a day on which the Index Exchange is scheduled to be open for trading for its regular trading sessions; and

"**Valuation Date**" means the date specified as such in the relevant Supplemental Listing Document.

3. Exercise of CBBCs, Mandatory Call Event, Automatic Exercise and Expiry

(a) *Exercise of CBBCs*. The CBBCs are exercisable on the Expiry Date, provided that a Mandatory Call Event has not occurred.

(b) *Mandatory Call Event.* Any CBBC in respect of which a Mandatory Call Event has occurred will automatically expire upon the occurrence of a Mandatory Call Event and every Board Lot will entitle the CBBC Holder to receive the Residual Value (if any) less any Exercise Expenses on the Settlement Date (as defined in Condition 4 below).

(c) *Automatic Exercise*. Any CBBC which has not automatically expired will automatically be exercised if, on the Expiry Date, the value of the Cash Settlement Amount is greater than zero (without prior notice being given to the CBBC Holders). The CBBC Holders will not be required to deliver any exercise notice and the Issuer or its agent will pay to the CBBC Holders the Cash Settlement Amount (if any) less any Exercise Expenses in accordance with Condition 4(d).

(d) *Issuer's Obligations*. For the avoidance of doubt, where the CBBCs have been exercised on the Expiry Date or have automatically expired upon the occurrence of a Mandatory Call Event (as the case may be), payment of the Cash Settlement Amount or the Residual Value (if any) (as the case may be) less any Exercise Expenses shall constitute full and final settlement of the obligations of the Issuer with respect to the CBBCs. Subject to such payment having been made, the Issuer shall have no obligation towards the relevant CBBC Holder under the CBBCs subsequent to such Expiry Date or the date on which a Mandatory Call Event occurs (as the case may be).

(e) *Expiry*. Any CBBC which does not automatically expire in accordance with Condition 3(b) or which has not been automatically exercised in accordance with Condition 3(c) (as the case may be) shall expire immediately without value thereafter and all rights of the CBBC Holder and obligations of the Issuer with respect to such CBBC shall cease.

4. Exercise of CBBCs, Cancellation and Payment

(a) *Board Lots*. CBBCs may only be exercised in a Board Lot or integral multiples thereof.

(b) *No requirement to deliver an exercise notice*. The CBBC Holders will not be required to deliver an exercise notice for any purpose in relation to the CBBCs.

(c) *Cancellation*. The Issuer will, with effect from the first Business Day following the date on which a Mandatory Call Event occurs or the Expiry Date (as the case may be), remove from its register the name of the person in respect of the CBBCs which (i) are the subject of an occurrence of a Mandatory Call Event; (ii) are the subject of an exercise pursuant to automatic exercise in accordance with these Conditions or (iii) have expired worthless, and thereby cancel the relevant CBBCs.

(d) *Cash Settlement*. Subject to automatic exercise of CBBCs or the occurrence of a Mandatory Call Event in accordance with these Conditions, the Issuer will make a payment, in respect of every Board Lot, to the relevant CBBC Holder equal to the Cash Settlement Amount or the Residual Value (if any) (as the case may be) less any Exercise Expenses. If the Cash Settlement Amount or the Residual Value is equal to, or less than, the determined Exercise Expenses, no Cash Settlement Amount or Residual Value shall be payable by the Issuer.

The Cash Settlement Amount or the Residual Value (as the case may be) less determined Exercise Expenses shall be despatched no later than the Settlement Date by crediting that amount in accordance with the CCASS Rules, to the Designated Bank Account.

If as a result of a Settlement Disruption Event, it is not possible for the Issuer to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the CBBC Holder on the original Settlement Date, the Issuer shall use its reasonable endeavours to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the CBBC Holder as soon as reasonably practicable after the original Settlement Date. The Issuer will not be liable to the CBBC Holder for any interest in respect of the amount due or any loss or damage that such CBBC Holder may suffer as a result of the existence of the Settlement Disruption Event, nor shall the Issuer be liable under any circumstances for any acts or defaults of CCASS in relation to the performance of its duties in relation to the CBBCs.

If the Issuer determines, in its sole discretion (acting in good faith and in a commercially reasonable manner), that a Market Disruption Event has occurred on the Valuation Date, then the Issuer shall determine the Closing Level or, if applicable, the Exchange Rate on the basis of its good faith estimate of the Closing Level or, if applicable, the Exchange Rate that would have prevailed on that day but for the occurrence of the Market Disruption Event provided that in the case of determining the Closing Level, the Issuer, if applicable, may, but shall not be obliged to, determine such Closing Level by having regard to the manner in which futures contracts relating to the Index are calculated.

5. Register

The Issuer will at all times maintain or arrange for the maintenance of a register in Hong Kong.

6. Adjustments to the Index

(a) *Successor Index Compiler Calculates and Reports Index*. If the Index is (i) not calculated and announced by the Index Compiler but is calculated and published by a successor to the Index Compiler (the "**Successor Index Compiler**") acceptable to the Issuer or (ii) replaced by a successor index using, in the determination of the Issuer, the same or a substantially similar formula for and method of calculation as used in the calculation of the Index, then the Index will be deemed to be the index so calculated and announced by the Successor Index Compiler or that successor index, as the case may be.

(b) *Modification and Cessation of Calculation of Index.*

If:

(i) on or prior to a Valuation Date the Index Compiler or (if applicable) the Successor Index Compiler makes a material change in the formula for or the method of calculating the Index or in any other way materially modifies the Index (other than a modification prescribed in that formula or method to maintain the Index in the event of changes in constituent stock, contracts or commodities and other routine events); or

(ii) on a Valuation Date the Index Compiler or (if applicable) the Successor Index Compiler fails to calculate and publish the Index (other than as a result of a Market Disruption Event),

then the Issuer shall determine the Closing Level using, in lieu of a published level for the Index, the level for the Index as at that Valuation Date as determined by the Issuer in accordance with the formula for and method of calculating the Index last in effect prior to that change or failure, but using only those securities/ commodities that comprised the Index immediately prior to that change or failure.

(c) *Other Adjustments*. Without prejudice to and notwithstanding any prior adjustment(s) made pursuant to the applicable Conditions, the Issuer may (but shall not be obliged to) make such other adjustments to the terms and conditions of the CBBCs as appropriate where any event (including the events as contemplated in the applicable Conditions) occurs and irrespective of, in substitution for, or in addition to the provisions contemplated in the applicable Conditions, provided that such adjustment is:

(i) not materially prejudicial to the interests of the CBBC Holders generally (without considering the circumstances of any individual CBBC Holder or the tax or other consequences of such adjustment in any particular jurisdiction); or

(ii) determined by the Issuer in good faith to be appropriate and commercially reasonable.

(d) *Notice of Determinations*. All determinations made by the Issuer pursuant hereto will be conclusive and binding on the CBBC Holders. The Issuer will give, or procure that there is given, notice as soon as practicable of any determinations by publication in accordance with Condition 11.

7. Illegality or Impracticability

The Issuer is entitled to terminate the CBBCs if it determines in good faith and in a commercially reasonable manner that, for reasons beyond its control, it has become or it will become illegal or impracticable:

(a) for it to perform its obligations under the CBBCs, in whole or in part, as a result of: (i) the adoption of, any change in, any relevant law or regulation (including any tax law); or (ii) the promulgation of, or any change in the interpretation by any court, tribunal, governmental, administrative, legislative, regulatory or judicial authority or power with competent jurisdiction of any relevant law or regulation (including any tax law), (each of (i) and (ii), a "**Change in Law Event**"); or

(b) for it or any of its affiliates to maintain the Issuer's hedging arrangements with respect to the CBBCs due to a Change in Law Event.

Upon the occurrence of a Change in Law Event, the Issuer will, if and to the extent permitted by applicable law or regulation, pay to each CBBC Holder a cash amount that Issuer determines in good faith and in a commercially reasonable manner to be the fair market value in respect of each CBBC held by such CBBC Holder immediately prior to such termination (ignoring such illegality or impracticability) less the cost to the Issuer of unwinding any related hedging arrangement and any charges or expenses including any taxes or duties which are incurred or withheld as determined by the Issuer in its sole and absolute discretion (acting in good faith and in a commercially reasonable manner). Payment will be made in such manner as shall be notified to the CBBC Holders in accordance with Condition 11.

8. Purchases

The Issuer and/or any of its subsidiaries and affiliates may at any time purchase CBBCs at any price in the open market or by tender or by private treaty. Any CBBCs so purchased may be held or resold or surrendered for cancellation.

9. Global Certificate

The CBBCs are represented by the Global Certificate registered in the name of HKSCC Nominees Limited and deposited with CCASS in accordance with the CCASS Rules. CBBC Holders will not be entitled to definitive certificates in respect of any CBBCs issued or transferred to them.

10. Meetings of CBBC Holders; Modification

(a) *Meetings of CBBC Holders*. The Instrument contains provisions for convening meetings of the CBBC Holders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution (as defined in the Instrument) of a modification of the provisions of the CBBCs or of the Global Certificate.

Any resolution to be passed in a meeting of the CBBC Holders shall be decided by poll. Such a meeting may be convened by the Issuer or by CBBC Holders holding not less than 10 per cent. of the CBBCs for the time being remaining unexercised. The quorum at any such meeting for passing an Extraordinary Resolution will be two or more persons holding or representing not less than 25 per cent. of the CBBCs for the time being remaining unexercised, or at any adjourned meeting two or more persons being or representing CBBC Holders whatever the number of CBBCs so held or represented.

A resolution will be an Extraordinary Resolution when it has been passed at a duly convened meeting by not less than three-quarters of the votes cast by such CBBC Holders who, being entitled to do so, vote in person or by proxy.

An Extraordinary Resolution passed at any meeting of the CBBC Holders shall be binding on all the CBBC Holders, whether or not they are present at the meeting.

Resolutions can be passed in writing without a meeting of the CBBC Holders being held if passed unanimously.

(b) *Modification*. The Issuer may, without the consent of the CBBC Holders, effect any modification of the terms and conditions of the CBBCs or the Global Certificate which, in the opinion of the Issuer, is:

(i) not materially prejudicial to the interests of the CBBC Holders generally (without considering the circumstances of any individual CBBC Holder or the tax or other consequences of such modification in any particular jurisdiction);

(ii) of a formal, minor or technical nature;

(iii) made to correct a manifest error; or

(iv) necessary in order to comply with mandatory provisions of the laws or regulations of Hong Kong.

Any such modification shall be binding on the CBBC Holders and shall be notified to them by the Issuer as soon as practicable in accordance with Condition 11.

11. Notices

All notices to CBBC Holders will be validly given if published in English and in Chinese on the website of Hong Kong Exchanges and Clearing Limited. Such notices shall be deemed to have been given on the date of the first such publication. If publication is not practicable, notice will be given in such other manner as the Issuer may determine.

12. Further Issues

The Issuer shall be at liberty from time to time, without the consent of the CBBC Holders, to create and issue further CBBCs so as to form a single series with the CBBCs.

13. Governing Law

The CBBCs, the Global Certificate and the Instrument will be governed by and construed in accordance with the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**"). The Issuer and each CBBC Holder (by its purchase of the CBBCs) shall be deemed to have submitted for all purposes in connection with the CBBCs, the Global Certificate and the Instrument to the non-exclusive jurisdiction of the courts of Hong Kong.

14. Language

In the event of any inconsistency between the Chinese translation of these Conditions and the English version of these Conditions, the English version of these Conditions shall prevail.

The relevant terms and conditions will, together with the supplemental provisions contained in the relevant supplemental listing document and subject to completion and amendment, be endorsed on the global certificate. The applicable supplemental listing document in relation to the issue of any series of structured products may specify additional terms and conditions which shall, to the extent so specified or to the extent inconsistent with the relevant terms and conditions, replace or modify the relevant terms and conditions for the purpose of such series of structured products. Capitalised terms used in the relevant terms and conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE UNIT FUND CALLABLE BULL/BEAR CONTRACTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. The Callable Bull/Bear Contracts (the "**CBBCs**") (which expression shall, unless the context otherwise requires, include any further CBBCs issued pursuant to Condition 13) relating to the Units of the Fund are issued in registered form subject to and with the benefit of a global certificate by way of deed poll (the "**Global Certificate**") dated the Issue Date, made by The Hongkong and Shanghai Banking Corporation Limited (the "**Issuer**") and an instrument by way of deed poll dated 2 April 2012 executed by the Issuer (the "**Instrument**") Copies of the Global Certificate and the Instrument are available for inspection at the specified office of the Issuer. The CBBC Holders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of all the provisions of the Global Certificate and the Instrument.

(b) *Status*. The CBBCs represent general, unsecured, contractual obligations of the Issuer and of no other person and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured obligations of the Issuer.

(c) *Transfer*. Transfers of beneficial interests in the CBBCs may be effected only in Board Lots or integral multiples thereof in CCASS (as defined below) in accordance with the CCASS Rules (as defined below).

(d) *Title*. Each person who is for the time being shown in the register kept by the Issuer as entitled to a particular number of CBBCs shall be treated by the Issuer as the absolute owner and holder of such number of CBBCs. The expression "**CBBC Holder**" shall be construed accordingly.

2. CBBC Rights and Exercise Expenses

(a) *CBBC Rights*. Every Board Lot gives each CBBC Holder, (i) upon due exercise and compliance with Condition 4, the right to receive the payment of the Cash Settlement Amount, (if any) less any Exercise Expenses or (ii) upon compliance with Condition 4, the right to receive the payment of the Residual Value, (if any) less any Exercise Expenses following the occurrence of a Mandatory Call Event (all as defined below).

(b) *Exercise Expenses*. On expiry of the CBBCs or upon the occurrence of a Mandatory Call Event, CBBC Holders are required to pay the Exercise Expenses. To effect such payment, an irrevocable authorisation to deduct the Exercise Expenses from the applicable Cash Settlement Amount or the Residual Value (as the case may be) is deemed to be given by a CBBC Holder to the Issuer upon purchase of the CBBCs. Any Exercise Expenses which have not been determined on the Expiry Date or following the Mandatory Call Event shall be notified to the CBBC Holder as soon as practicable after determination thereof by the Issuer and shall be paid by the CBBC Holder immediately upon demand.

(c) *Definitions*. For the purposes of these Conditions:

"**Board Lot**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Business Day**" means a day (excluding Saturdays) on which the Stock Exchange (as defined below) is scheduled to open for dealings in Hong Kong and banks are open for business in Hong Kong;

"**Call Price**" means the price of the Units specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Cash Settlement Amount**" means:

(1) in the case of a series of bull CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

$$\text{Cash Settlement Amount per Board Lot} = \frac{\text{Entitlement x (Closing Price – Strike Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

(2) in the case of a series of bear CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

$$\text{Cash Settlement Amount per Board Lot} = \frac{\text{Entitlement x (Strike Price – Closing Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

provided that if the Cash Settlement Amount is a negative amount it shall be deemed to be zero;

"**CCASS**" means the Central Clearing and Settlement System established and operated by Hong Kong Securities Clearing Company Limited ("**HKSCC**");

"**CCASS Rules**" means the General Rules of CCASS and the CCASS Operational Procedures in effect from time to time;

"**CCASS Settlement Day**" has the meaning ascribed to the term "Settlement Day" in the General Rules of CCASS, subject to such modification and amendment prescribed by HKSCC from time to time;

"**Closing Price**" means the official closing price of one Unit (as derived from the Daily Quotation Sheet of the Stock Exchange, subject to any adjustments to such closing price as may be necessary to reflect any capitalisation, rights issue, distribution or the like) on the Valuation Date (as defined below);

"**Entitlement**" means the number specified as such in the relevant Supplemental Listing Document, subject to any adjustment in accordance with Condition 6;

"**Exercise Expenses**" means any charges or expenses including any taxes or duties which are incurred or withheld in respect of the expiry of the CBBCs or the occurrence of a Mandatory Call Event (as the case may be);

"**Expiry Date**" means the date specified as such in the relevant Supplemental Listing Document;

"**Fund**" means the fund specified as such in the relevant Supplemental Listing Document;

“**IEP**” means the indicative equilibrium price, as determined in accordance with the Rules and Regulations of the Stock Exchange prescribed by the Stock Exchange from time to time (the “**Trading Rules**”);

“**Mandatory Call Event**” occurs:

(1) in the case of a series of bull CBBCs, if the Spot Price is at or below the Call Price at any time during a Trading Day in the Observation Period; and

(2) in the case of a series of bear CBBCs, if the Spot Price is at or above the Call Price at any time during a Trading Day in the Observation Period;

“**Market Disruption Event**” means:

(1) (i) with respect to exercise of the CBBCs, the occurrence or existence on the Valuation Date during the one-half hour period that ends at the close of trading of, or (ii) with respect to the determination of the Residual Value, the occurrence or existence during a trading session resulting in any suspension of or limitation imposed on trading (by reason of movements in price exceeding limits permitted by the Stock Exchange or otherwise) on the Stock Exchange in

(a) the Units; and/or

(b) any options or futures contracts relating to the Units if, in any such case, that suspension or limitation is, in the determination of the Issuer, material; or

(2) (i) with respect to exercise of the CBBCs, the issuance of the tropical cyclone warning signal number 8 or above or a “BLACK” rainstorm signal which either results in the Stock Exchange being closed for dealings for an entire day or results in the Stock Exchange being closed prior to its regular time for close of trading on any day, provided that there shall be no Market Disruption Event solely by reason of the Stock Exchange opening later than its regular time for open of trading on any day as a result of the tropical cyclone warning signal number 8 or above or the BLACK rainstorm signal having been issued, or (ii) with respect to the determination of the Residual Value and in respect of a trading session, the issuance of the tropical cyclone warning signal number 8 or above or a BLACK rainstorm signal which results in the Stock Exchange being closed for dealings; or

(3) a limitation or closure of the Stock Exchange due to any unforeseen circumstances;

“**Maximum Trade Price**” means the highest Spot Price during the MCE Valuation Period;

“**MCE Valuation Period**” means the period commencing from and including the moment upon which the Mandatory Call Event occurs (the trading session during which the Mandatory Call Event occurs is the “**First Session**”) and up to the end of the trading session on the Stock Exchange immediately following the First Session (the “**Second Session**”) unless, in the determination of the Issuer in good faith, the Second Session for any reason (including, without limitation, a Market Disruption Event occurring and subsisting in the Second Session) does not contain any continuous period of one hour or more than one hour during which trading in the Units is permitted on the Stock Exchange with no limitation imposed, in which case the MCE Valuation Period shall be extended to the end of the subsequent trading session following the Second Session during which trading in the Units is permitted on the Stock Exchange with no limitation imposed for a continuous period of at least one hour notwithstanding the existence or continuance of a Market Disruption Event in such postponed trading session, unless the Issuer determines in good faith that each trading session on each of the four Trading Days immediately following the date on which the Mandatory Call Event occurs does not contain any continuous period of one hour or more than one hour during which trading in the Units is permitted on the Stock Exchange with no limitation imposed. In that case:

(i) the period commencing from the First Session up to, and including, the last trading session on the Stock Exchange of the fourth Trading Day immediately following the date on which the Mandatory Call Event occurs shall be deemed to be the MCE Valuation Period; and

(ii) the Issuer shall determine the Maximum Trade Price or the Minimum Trade Price (as the case may be) having regard to the then prevailing market conditions, the last reported Spot Price and such other factors as the Issuer may determine to be relevant in good faith.

For the avoidance of doubt, all Spot Prices available throughout the extended MCE Valuation Period shall be taken into account to determine the Maximum Trade Price or the Minimum Trade Price (as the case may be) for the calculation of the Residual Value.

For the purposes of this definition,

(a) the pre-opening session, the morning session and, in the case of half day trading, the closing auction session (if any) of the same day; and

(b) the afternoon session and the closing auction session (if any) of the same day,

shall each be considered as one trading session only;

"**Minimum Trade Price**" means the lowest Spot Price during the MCE Valuation Period;

"**Observation Commencement Date**" has the meaning specified in the relevant Supplemental Listing Document;

"**Observation Period**" means the period from the Observation Commencement Date to the Trading Day immediately preceding the Expiry Date (both dates inclusive);

"**Post MCE Trades**" means, subject to such modification and amendment prescribed by the Stock Exchange from time to time, (i) if the Mandatory Call Event occurs during a pre-opening session or a closing auction session (if applicable), as the case may be, of the Stock Exchange, all auction trades in the CBBC concluded in such session and all manual trades concluded after the end of the pre-order matching period in such session; or (ii) if the Mandatory Call Event occurs during a continuous trading session of the Stock Exchange, all trades of the CBBCs concluded via auto-matching or manually after the time of the occurence of a Mandatory Call Event;

"**Price Determination Date**" means the date on which the Maximum Trade Price or the Minimum Trade Price (as the case may be) is determined by the Issuer;

"**Residual Value**" will be calculated in accordance with the formula specified below by reference to the lowest Spot Price (in respect of a series of bull CBBCs) or the highest Spot Price (in respect of a series of bear CBBCs) of the underlying Units available during a MCE Valuation Period:

(1) in the case of a series of bull CBBCs and in respect of every Board Lot:

$$\frac{\text{Entitlement x (Minimum Trade Price – Strike Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

(2) in the case of a series of bear CBBCs and in respect of every Board Lot:

$$\frac{\text{Entitlement x (Strike Price – Maximum Trade Price) x one Board Lot}}{\text{Number of CBBCs per Entitlement}}$$

provided that if the Residual Value is a negative amount it shall be deemed to be zero;

"**Settlement Currency**" has the meaning given to it in the relevant Supplemental Listing Document;

"**Settlement Date**" means the third CCASS Settlement Day after (i) the end of the MCE Valuation Period or (ii) the later of (a) the Expiry Date; and (b) the day on which the Closing Price is determined in accordance with the Conditions (as the case may be);

"**Settlement Disruption Event**" means an event beyond the control of the Issuer as a result of which the Issuer is unable to procure payment electronically through CCASS to the relevant bank account designated by the relevant CBBC Holder ("**Designated Bank Account**");

"**Spot Price**" means:

(i) in respect of a continuous trading session of the Stock Exchange, the price per Unit concluded by means of automatic order matching on the Stock Exchange as reported in the official real-time dissemination mechanism for the Stock Exchange during such continuous trading session in accordance with the Trading Rules, excluding direct business (as defined in the Trading Rules); and

(ii) in respect of a pre-opening session or a closing auction session (if applicable) of the Stock Exchange (as the case may be), the final IEP of the Unit (if any) calculated at the end of the pre-order matching period of such pre-opening session or closing auction session (if applicable) (as the case may be) in accordance with the Trading Rules, excluding direct business (as defined in the Trading Rules),

subject to such modification and amendment prescribed by the Stock Exchange from time to time;

"**Stock Exchange**" means The Stock Exchange of Hong Kong Limited;

"**Strike Price**" has the meaning given to it in the relevant Supplemental Listing Document, subject to any adjustment in accordance with condition 6;

"**Trading Day**" means a day on which the Stock Exchange is scheduled to be open for trading for its regular trading sessions;

"**Units**" means the units of the Fund specified as such in the relevant Supplemental Listing Document; and

"**Valuation Date**" means the Trading Day immediately preceding the Expiry Date.

3. Exercise of CBBCs, Mandatory Call Event, Automatic Exercise and Expiry

(a) *Exercise of CBBCs*. The CBBCs are exercisable on the Expiry Date, provided that a Mandatory Call Event has not occurred.

(b) *Mandatory Call Event*. Any CBBC in respect of which a Mandatory Call Event has occurred will automatically expire upon the occurrence of a Mandatory Call Event and every Board Lot will entitle the CBBC Holder to receive the Residual Value (if any) less any Exercise Expenses on the Settlement Date (as defined in Condition 4 below).

(c) *Automatic Exercise*. Any CBBC which has not automatically expired will automatically be exercised if, on the Expiry Date, the value of the Cash Settlement Amount is greater than zero (without prior notice being given to the CBBC Holders). The CBBC Holders will not be required to deliver any exercise notice and the Issuer or its agent will pay to the CBBC Holders the Cash Settlement Amount (if any) less any Exercise Expenses in accordance with Condition 4(d).

(d) *Issuer's Obligations*. For the avoidance of doubt, where the CBBCs have been exercised on the Expiry Date or have automatically expired upon the occurrence of a Mandatory Call Event (as the case may be), payment of the Cash Settlement Amount or the Residual Value (if any) (as the case may be) less any Exercise Expenses shall constitute full and final settlement of the obligations of the Issuer with respect to the CBBCs. Subject to such payment having been made, the Issuer shall have no obligation towards the relevant CBBC Holder under the CBBCs subsequent to such Expiry Date or the date on which a Mandatory Call Event occurs (as the case may be).

(e) *Expiry*. Any CBBC which does not automatically expire in accordance with Condition 3(b) or which has not been automatically exercised in accordance with Condition 3(c) (as the case may be) shall expire immediately without value thereafter and all rights of the CBBC Holder and obligations of the Issuer with respect to such CBBC shall cease.

4. Exercise of CBBCs, Cancellation and Payment

(a) *Board Lots*. CBBCs may only be exercised in a Board Lot or integral multiples thereof.

(b) *No requirement to deliver an exercise notice*. The CBBC Holders will not be required to deliver an exercise notice for any purpose in relation to the CBBCs.

(c) *Cancellation*. The Issuer will, with effect from the first Business Day following the date on which a Mandatory Call Event occurs or the Expiry Date (as the case may be), remove from its register the name of the person in respect of the CBBCs which (i) are the subject of an occurrence of a Mandatory Call Event; (ii) are the subject of an exercise pursuant to automatic exercise in accordance with these Conditions; or (iii) have expired worthless, and thereby cancel the relevant CBBCs.

(d) *Cash Settlement*. Subject to automatic exercise of CBBCs or the occurrence of a Mandatory Call Event in accordance with these Conditions, the Issuer will make a payment, in respect of every Board Lot, to the relevant CBBC Holder equal to the Cash Settlement Amount or the Residual Value (if any) (as the case may be) less any Exercise Expenses. If the Cash Settlement Amount or the Residual Value is equal to, or less than, the determined Exercise Expenses, no Cash Settlement Amount or Residual Value shall be payable by the Issuer.

The Cash Settlement Amount or the Residual Value (as the case may be) less determined Exercise Expenses shall be despatched no later than the Settlement Date by crediting that amount in accordance with the CCASS Rules, to the Designated Bank Account.

If as a result of a Settlement Disruption Event, it is not possible for the Issuer to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the CBBC Holder on the original Settlement Date, the Issuer shall use its reasonable endeavours to procure payment electronically through CCASS by crediting the relevant Designated Bank Account of the CBBC Holder as soon as reasonably practicable after the original Settlement Date. The Issuer will not be liable to the CBBC Holder for any interest in respect of the amount due or any loss or damage that such CBBC Holder may suffer as a result of the existence of the Settlement Disruption Event, nor shall the Issuer be liable under any circumstances for any acts or defaults of CCASS in relation to the performance of its duties in relation to the CBBCs.

If the Issuer determines, in its sole discretion (acting in good faith and in a commercially reasonable manner), that a Market Disruption Event has occurred on the Valuation Date, then that Valuation Date shall be postponed to the first succeeding Trading Day on which the Issuer determines that there is no Market Disruption Event, unless the Issuer determines that there is a Market Disruption Event on each of the four Trading Days immediately following the original date that, but for the Market Disruption Event, would have been the Valuation Date. In that case:

(i) the fourth Trading Day immediately following the original date shall be deemed to be the Valuation Date, notwithstanding the Market Disruption Event; and

(ii) the Issuer shall determine the closing price of the Units having regard to the then prevailing market conditions, the last reported Spot Price and such other factors as the Issuer determines to be relevant in good faith.

5. Register

The Issuer will at all times maintain or arrange for the maintenance of a register in Hong Kong.

6. Adjustments

(a) *Rights Issues*. If and whenever the Fund shall, by way of Rights (as defined below), offer new Units for subscription at a fixed subscription price to the holders of existing Units pro rata to existing holdings (a "**Rights Offer**"), the Entitlement will be adjusted to take effect on the Business Day on which trading in the Units of the Fund becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{1 + M}{1 + (R/S) \times M}$$

E : Existing Entitlement immediately prior to the Rights Offer

S : Cum-Rights Unit price being the closing price of the Units on the Stock Exchange on the last Business Day on which the Units are traded on a cum-Rights basis

R : Subscription price per new Unit as specified in the Rights Offer plus an amount equal to any distributions or other benefits foregone to exercise the Right

M : Number of new Unit(s) (whether a whole or a fraction) per existing Unit each holder thereof is entitled to subscribe

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Call Price and/or Strike Price in accordance with the following formulas:

$$\begin{array}{c}\text{Adjusted Call Price}\\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Call Price} \times \frac{1}{\text{Adjustment Component}}$$

$$\text{Adjusted Strike Price (rounded to the nearest 0.001)} = \text{Strike Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

For the purposes of these Conditions:

"**Rights**" means the right(s) attached to each existing Unit or needed to acquire one new Unit (as the case may be) which are given to the holders of existing Units to subscribe at a fixed subscription price for new Units pursuant to the Rights Offer (whether by the exercise of one Right, a part of a Right or an aggregate number of Rights).

(b) *Bonus Issues*. If and whenever the Fund shall make an issue of Units credited as fully paid to the holders of Units generally (other than pursuant to a scrip distribution or similar scheme for the time being operated by the Fund or otherwise in lieu of a cash distribution and without any payment or other consideration being made or given by such holders) (a "**Bonus Issue**") the Entitlement will be increased on the Business Day on which trading in the Units of the Fund becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

Adjustment Component = (1 + N)

E : Existing Entitlement immediately prior to the Bonus Issue

N : Number of additional Units (whether a whole or a fraction) received by a holder of existing Units for each Unit held prior to the Bonus Issue

Provided that if the adjustment to be made would result in the Entitlement being changed by one per cent. or less, then no adjustment will be made to the Entitlement. In addition, the Issuer shall adjust the Call Price and/or Strike Price in accordance with the following formulas:

$$\text{Adjusted Call Price (rounded to the nearest 0.001)} = \text{Call Price} \times \frac{1}{\text{Adjustment Component}}$$

$$\text{Adjusted Strike Price (rounded to the nearest 0.001)} = \text{Strike Price} \times \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

(c) *Unit Splits or Consolidations*. If and whenever the Fund shall subdivide its Units or any class of its outstanding units into a greater number of units (a "**Subdivision**") or consolidate the Units or any class of its outstanding units into a smaller number of units (a "**Consolidation**"), the Entitlement in effect immediately prior thereto will be increased (in the case of a Subdivision) or decreased (in the case of a Consolidation) accordingly in each case on the day on which the relevant Subdivision or Consolidation shall have taken effect. In addition, the Call Price and/or Strike Price (each of which shall be rounded to the nearest 0.001) will be decreased (in the case of a Subdivision) or increased (in the case of a Consolidation) accordingly.

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

(d) *Merger or Consolidation*. If it is announced that the Fund is to or may merge with or into any other fund or consolidate with or into any other fund or corporation (including becoming, by agreement or otherwise, controlled by any person or corporation) (except where the Fund is the surviving entity in a merger) or that it is to or may sell or transfer all or substantially all of its assets, the rights attaching to the CBBCs may in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner) be amended no later than the Business Day preceding the consummation of such merger, consolidation, sale or transfer (each a "**Restructuring Event**") (as determined by the Issuer in its absolute discretion (acting in good faith and in a commercially reasonable manner)).

The rights attaching to the CBBCs after the adjustment shall, after such Restructuring Event, relate to the number of units of the fund(s) resulting from or surviving such Restructuring Event or other securities ("**Substituted Securities**") and/or cash offered in substitution for the affected Units, as the case may be, to which the holder of such number of Units to which the CBBCs related immediately before such Restructuring Event would have been entitled upon such Restructuring Event. Thereafter the provisions hereof shall apply to such Substituted Securities, provided that any Substituted Securities may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be deemed to be replaced by an amount in the relevant currency equal to the market value or, if no market value is available, fair value, of such Substituted Securities in each case as determined by the Issuer as soon as practicable after such Restructuring Event is effected.

For the avoidance of doubt, any remaining Units shall not be affected by this paragraph (d) and, where cash is offered in substitution for Units or is deemed to replace Substituted Securities as described above, references in these Conditions to the Units shall include any such cash.

(e) *Cash Distributions*. Generally, no adjustment will be made for an ordinary cash distribution (whether or not it is offered with a scrip alternative). For any other forms of cash distribution (each a "**Cash Distribution**") announced by the Fund, no adjustment will be made unless the value of the Cash Distribution accounts for two per cent. or more of the Unit's closing price on the day of announcement by the Fund.

If and whenever the Fund shall make a Cash Distribution credited as fully paid to the holders of Units generally, the Entitlement will be adjusted to take effect on the Business Day on which trading in the Units of the Fund becomes ex-entitlement in accordance with the following formula:

$$\text{Adjusted Entitlement} = \text{Adjustment Component} \times E$$

Where:

$$\text{Adjustment Component} = \frac{X - B}{X - B - C}$$

provided that B shall be deducted from X only if the Business Day on which trading in the Units of the Fund becomes ex-entitlement with respect to the Cash Distribution and the distribution of the ordinary cash distribution by the Fund falls on the same date.

B: Amount of the relevant ordinary cash distribution per Unit

C: Amount of the relevant Cash Distribution per Unit

E: Existing Entitlement immediately prior to the Cash Distribution

X: Cum-Cash Distribution Unit price being the closing price of the Units on the Stock Exchange on the last Business Day on which the Units of the Fund are traded on a cum-Cash Distribution basis

In addition, the Issuer shall adjust the Call Price and/or Strike Price in accordance with the following formulas:

$$\begin{array}{c}\text{Adjusted Call Price}\\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Call Price x } \frac{1}{\text{Adjustment Component}}$$

$$\begin{array}{c}\text{Adjusted Strike Price}\\ \text{(rounded to the nearest 0.001)}\end{array} = \text{Strike Price x } \frac{1}{\text{Adjustment Component}}$$

Adjustment to the Call Price and/or Strike Price shall take effect on the same day that the Entitlement is adjusted.

(f) *Other Adjustments*. Without prejudice to and notwithstanding any prior adjustment(s) made pursuant to the applicable Condition, the Issuer may (but shall not be obliged to) make such other adjustments to the terms and conditions of the CBBCs as appropriate where any event (including the events as contemplated in the applicable Conditions) occurs and irrespective of, in substitution for, or in addition to the provisions contemplated in the applicable Conditions, provided that such adjustment is:

(i) not materially prejudicial to the interests of the CBBC Holders generally (without considering the circumstances of any individual CBBC Holder or the tax or other consequences of such adjustment in any particular jurisdiction); or

(ii) determined by the Issuer in good faith to be appropriate and commercially reasonable.

For the avoidance of doubt, such adjustments may, but need not, be determined by reference to the adjustment(s) made in respect of such event or events by an options exchange to options on the relevant Units traded on such options exchange.

(g) *Notice of Adjustments*. All determinations made by the Issuer pursuant hereto will be conclusive and binding on the CBBC Holders. The Issuer will give, or procure that there is given, notice as soon as practicable of any adjustment and of the date from which such adjustment is effective by publication in accordance with Condition 11.

7. Illegality or Impracticability

The Issuer is entitled to terminate the CBBCs if it determines in good faith and in a commercially reasonable manner that, for reasons beyond its control, it has become or it will become illegal or impracticable:

(a) for it to perform its obligations under the CBBCs, in whole or in part, as a result of: (i) the adoption of, any change in, any relevant law or regulation (including any tax law); or (ii) the promulgation of, or any change in the interpretation by any court, tribunal, governmental, administrative, legislative, regulatory or judicial authority or power with competent jurisdiction of any relevant law or regulation (including any tax law), (each of (i) and (ii), a "**Change in Law Event**"); or

(b) for it or any of its affiliates to maintain the Issuer's hedging arrangements with respect to the CBBCs due to a Change in Law Event.

Upon the occurrence of a Change in Law Event, the Issuer will, if and to the extent permitted by applicable law or regulation, pay to each CBBC Holder a cash amount that Issuer determines in good faith and in a commercially reasonable manner to be the fair market value in respect of each CBBC held by such CBBC Holder immediately prior to such termination (ignoring such illegality or impracticability) less the cost to the Issuer of unwinding any related hedging arrangement and any charges or expenses including any taxes or duties which are incurred or withheld as determined by the Issuer in its sole and absolute discretion (acting in good faith and in a commercially reasonable manner). Payment will be made in such manner as shall be notified to the CBBC Holders in accordance with Condition 11.

8. Purchases

The Issuer and/or any of its subsidiaries and affiliates may at any time purchase CBBCs at any price in the open market or by tender or by private treaty. Any CBBCs so purchased may be held or resold or surrendered for cancellation.

9. Global Certificate

The CBBCs are represented by the Global Certificate registered in the name of HKSCC Nominees Limited and deposited with CCASS in accordance with the CCASS Rules. CBBC Holders will not be entitled to definitive certificates in respect of any CBBCs issued or transferred to them.

10. Meetings of CBBC Holders; Modification

(a) *Meetings of CBBC Holders*. The Instrument contains provisions for convening meetings of the CBBC Holders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution (as defined in the Instrument) of a modification of the provisions of the CBBCs or of the Global Certificate.

Any resolution to be passed in a meeting of the CBBC Holders shall be decided by poll. Such a meeting may be convened by the Issuer or by CBBC Holders holding not less than 10 per cent. of the CBBCs for the time being remaining unexercised. The quorum at any such meeting for passing an Extraordinary Resolution will be two or more persons holding or representing not less than 25 per cent. of the CBBCs for the time being remaining unexercised, or at any adjourned meeting two or more persons being or representing CBBC Holders whatever the number of CBBCs so held or represented.

A resolution will be an Extraordinary Resolution when it has been passed at a duly convened meeting by not less than three-quarters of the votes cast by such CBBC Holders who, being entitled to do so, vote in person or by proxy.

An Extraordinary Resolution passed at any meeting of the CBBC Holders shall be binding on all the CBBC Holders, whether or not they are present at the meeting.

Resolutions can be passed in writing without a meeting of the CBBC Holders being held if passed unanimously.

(b) *Modification*. The Issuer may, without the consent of the CBBC Holders, effect any modification of the terms and conditions of the CBBCs or the Global Certificate which, in the opinion of the Issuer, is:

(i) not materially prejudicial to the interests of the CBBC Holders generally (without considering the circumstances of any individual CBBC Holder or the tax or other consequences of such modification in any particular jurisdiction);

(ii) of a formal, minor or technical nature;

(iii) made to correct a manifest error; or

(iv) necessary in order to comply with mandatory provisions of the laws or regulations of Hong Kong.

Any such modification shall be binding on the CBBC Holders and shall be notified to them by the Issuer as soon as practicable in accordance with Condition 11.

11. Notices

All notices to CBBC Holders will be validly given if published in English and in Chinese on the website of Hong Kong Exchanges and Clearing Limited. Such notices shall be deemed to have been given on the date of the first such publication. If publication is not practicable, notice will be given in such other manner as the Issuer may determine.

12. Liquidation

In the event of (i) a liquidation, dissolution or termination of the Fund or (ii) the appointment of a liquidator, receiver or administrator or analogous person under applicable law in respect of the whole or substantially the whole of its undertaking, property or assets or (iii) the withdrawal of the Securities and Futures Commission's authorisation of the Fund under the Securities and Futures Ordinance, all unexercised CBBCs will lapse and shall cease to be valid for any purpose, in the case of (i) voluntary liquidation, on the effective date of the relevant resolution, (ii) an involuntary liquidation or dissolution, on the date of the relevant court order, (iii) a termination, on the effective date of the termination, (iv) the appointment of a liquidator or receiver or administrator or analogous person under any applicable law in respect of the whole or substantially the whole of its undertaking, property or assets, on the date on which such appointment is effective, or (v) withdrawal of authorisation, on the date on which such withdrawal becomes effective, but subject (in any such case) to any contrary mandatory requirement of law.

13. Further Issues

The Issuer shall be at liberty from time to time, without the consent of the CBBC Holders, to create and issue further CBBCs so as to form a single series with the CBBCs.

14. Delisting

(a) If at any time the Units cease to be listed on the Stock Exchange, the Issuer shall give effect to these Conditions in such manner and make such adjustments to the rights attaching to the CBBCs as it shall, in its absolute discretion (acting in good faith and in a commercially reasonable manner), consider appropriate to ensure, so far as it is reasonably able to do so, that the interests of the CBBC Holders generally are not materially prejudiced as a consequence of such delisting (without considering the individual circumstances of any CBBC Holder or the tax or other consequences that may result in any particular jurisdiction).

(b) Without prejudice to the generality of Condition 14(a), where the Units are, or, upon the delisting, become, listed on any other stock exchange, these Conditions may, in the absolute discretion of the Issuer (acting in good faith and in a commercially reasonable manner), be amended to the extent necessary to allow for the substitution of that other stock exchange in place of the Stock Exchange and the Issuer may, without the consent of the CBBC Holders, make such adjustments to the entitlements of CBBC Holders on exercise (including, if appropriate, by converting foreign currency amounts at prevailing market rates into the relevant currency) as may be appropriate in the circumstances.

(c) The Issuer shall determine, in its absolute discretion (acting in good faith and in a commercially reasonable manner), any adjustment or amendment and its determination shall be conclusive and binding on the CBBC Holders save in the case of manifest error. Notice of any adjustments or amendments shall be given to the CBBC Holders in accordance with Condition 11 as soon as practicable after they are determined.

15. Governing Law

The CBBCs, the Global Certificate and the Instrument will be governed by and construed in accordance with the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**"). The Issuer and each CBBC Holder (by its purchase of the CBBCs) shall be deemed to have submitted for all purposes in connection with the CBBCs, the Global Certificate and the Instrument to the non-exclusive jurisdiction of the courts of Hong Kong.

16. Language

In the event of any inconsistency between the Chinese translation of these Conditions and the English version of these Conditions, the English version of these Conditions shall prevail.

INFORMATION ABOUT US

Incorporation and business

The Bank was established with limited liability in the Hong Kong Special Administrative Region (the "**Hong Kong SAR**") by The Hongkong and Shanghai Bank Ordinance 1866, as continued by The Hongkong and Shanghai Banking Corporation Limited Ordinance (Cap. 70) of Hong Kong (as amended) (the "**Ordinance**"). On 6 October 1989, the Bank was registered pursuant to Part IX of the Companies Ordinance (Cap. 32) of Hong Kong with company number 263876 and its then name was changed to "The Hongkong and Shanghai Banking Corporation Limited". On 6 June 1997, Memorandum and Articles of Association were adopted, replacing the Ordinance in part and superseding The Hongkong and Shanghai Bank Regulations (Cap. 70A) of Hong Kong which formerly were the constitutive documents of the Bank. Its registered and head office is situated at 1 Queen's Road Central, Hong Kong. It is the largest bank incorporated in the Hong Kong SAR and is one of the three banks in the Hong Kong SAR which are currently authorised by the Government of the Hong Kong SAR to issue Hong Kong currency notes.

Serving the financial and wealth management needs of an international customer base, the Bank Group provides a range of personal, commercial and corporate banking and related financial services in 20 countries and territories in Asia-Pacific – with the largest network of any international financial institution in the region – and in six other countries around the world. Employing some 65,600 people, of whom 34,000 work for the Bank itself, the Bank Group had consolidated assets at 31 December 2012 of HK$6,065 billion.

The Bank is a wholly-owned subsidiary of HSBC Holdings plc. HSBC Holdings plc and its subsidiaries (the "**HSBC Group**") have an international network covering 81 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America.

Directors and Secretary

As at the date of this document, the Directors and Secretary of the Bank are set out below.

Name of Directors

Stuart T Gulliver, Chairman
Dr William Fung Kwok Lun*, SBS, OBE, Deputy Chairman
Laura Cha May Lung*, GBS, Deputy Chairman
Peter Wong Tung Shun, Chief Executive
Graham John Bradley*
Dr Raymond Ch'ien Kuo Fung*, GBS, CBE
Naina L Kidwai
Rose Lee Wai Mun
Victor Li Tzar Kuoi*
Zia Mody*
Christopher D Pratt*
James Riley*
Andreas Sohmen-Pao*
T Brian Stevenson*, SBS
Dr Rosanna Wong Yick-ming*, DBE
Marjorie Yang Mun Tak*
Tan Sri Dr Francis Yeoh Sock Ping*, CBE

Name of Secretary

Paul A Stafford, ACIS

* Non-executive Director of the Bank

Principal Subsidiaries

The principal subsidiaries of the Bank as at the date of this document are set out below:

Name	Place of Incorporation	Nominal value of issued share capital/registered capital	Class of share/ registered capital	Bank's interest in issued share capital/registered capital	Principal activity
Hang Seng Bank Limited [1]	Hong Kong SAR	HK$9,559 million	Ordinary	62.14 per cent.	Banking
HSBC Bank (China) Company Limited [1]	People's Republic of China	RMB12,400 million	Registered capital	100 per cent.	Banking
HSBC Bank Malaysia Berhad [1]	Malaysia	RM$115 million	Ordinary	100 per cent.	Banking
HSBC Bank Australia Limited [2]	Australia	A$811 million	Ordinary	100 per cent.	Banking
HSBC Bank (Taiwan) Limited [2]	Taiwan	TWD30,000 million	Ordinary	100 per cent.	Banking
HSBC Insurance (Asia) Limited [2]	Hong Kong SAR	HK$2,798 million	Ordinary	100 per cent.	Insurance
HSBC Life (International) Limited [2]	Bermuda	HK$2,778 million	Ordinary	100 per cent.	Retirement benefits and life insurance

1 Held directly
2 Held indirectly

The principal countries of operation are the same as the countries of incorporation except for HSBC Life (International) Limited which operates mainly in the Hong Kong SAR.

Share capital

The following shows the authorised and the issued and fully paid share capital of the Bank as at the date of this document:

Authorised:

The authorised ordinary share capital of the Bank was HK$80,000 million divided into 32,000 million ordinary shares of HK$2.50 each. The authorised preference share capital of the Bank was U.S.$13,450,500,000 comprising 3,750,500,000 cumulative redeemable preference shares of U.S.$1.00 each, 7,500,000,000 non-cumulative irredeemable preference shares of U.S.$1.00 each and 2,200,000,000 cumulative irredeemable preference shares of U.S.$1.00 each.

Issued:

The issued and fully paid-up ordinary share capital of the Bank was made up of HK$58,968,707,252.50 comprising 23,587,482,901 ordinary shares of HK$2.50 each. The issued and fully paid up preference share capital was U.S.$7,388,500,000 comprising 1,450,500,000 cumulative redeemable preference shares of U.S.$1.00 each, 4,853,000,000 non-cumulative irredeemable preference shares of U.S.$1.00 each and 1,085,000,000 cumulative irredeemable preference shares of U.S.$1.00 each.

In accordance with Hong Kong Accounting Standard 32 *Financial Instruments: Presentation*, the issued and fully paid up preference shares are presented as liabilities in the consolidated balance sheet and the balance sheet of the Bank.

Total shareholders' equity

The total shareholders' equity of the Bank Group as at 31 December 2012 was HK$437,399 million comprising HK$58,969 million of share capital, HK$133,790 million of other reserves, HK$224,640 million of retained profits and HK$20,000 million of proposed fourth interim dividend.

Subordinated liabilities

Subordinated liabilities of the Bank Group, as at 31 December 2011 and 2012, consists of undated primary capital notes and other loan capital having an original term to maturity of five years or more, raised by the Bank Group for the development and expansion of its business.

	2012	**2011**
	HK$m	*HK$m*
Bank Group subordinated liabilities	13,867	16,114

Debt Securities in Issue

The debt securities in issue of the Bank Group as at 31 December 2012 were HK$74,647 million.

General

We have not or will not take any action that would permit a public offering of structured products or possession or distribution of any offering material in relation to the structured products in any jurisdiction where action for that purpose is required. No offers, sales or deliveries of any structured products, or distribution of any offering material relating to the structured products, may be made in or from any jurisdiction except in circumstances which will result in compliance with any applicable laws or regulations and will not impose any obligations on us. You are required to inform yourself about, and to observe, all such applicable laws and regulations.

United States of America

The structured products have not been, and will not be, registered under the U.S. Securities Act of 1933, as amended (the "**Securities Act**"). Structured products, or interests therein, may not at any time be offered, sold, resold or delivered, directly or indirectly, in the United States or to, or for the account or benefit of, any U.S. person or to others for offering, sale or resale in the United States or to any such U.S. person. Offers and sales of structured products, or interests therein, in the United States or to U.S. persons would constitute a violation of United States securities laws unless made in compliance with the registration requirements of the Securities Act or pursuant to an exemption therefrom. The structured products will not be offered, sold or delivered within the United States or to U.S. persons. As used herein, "**United States**" means the United States of America (including the States and the District of Columbia), its territories, its possessions and other areas subject to its jurisdiction; and "**U.S. person**" means any national or resident of the United States, including any corporation, partnership or other entity created or organised in or under the laws of the United States or of any political subdivision thereof, any estate or trust the income of which is subject to United States income taxation regardless of its source, and any other U.S. person as such term is defined in Regulation S under the Securities Act.

Public Offer Selling Restriction under the Prospectus Directive

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a "**Relevant Member State**"), with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the "**relevant implementation date**") the structured products may not be offered to the public in that relevant member state, except that, with effect from and including the relevant implementation date, the structured products may be offered to the public in that Relevant Member State:

(a) at any time to any legal entity which is a qualified investor as defined in the Prospectus Directive;

(b) at any time to fewer than 100 or, if the Relevant Member State has implemented the relevant provision of the 2010 PD Amending Directive, 150, natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining our prior consent for any such offer; or

(c) at any time in any other circumstances falling within Article 3(2) of the Prospectus Directive,

provided that no such offer of structured products referred to in (a) to (c) above shall require us to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive.

For the purposes of this provision, the expression relating to an "**offer of structured products to the public**" in relation to any structured products in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the structured products to be offered so as to enable an investor to decide to purchase or subscribe the structured products, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression "**Prospectus Directive**" means Directive 2003/71/EC (and amendments thereto, including the 2010 PD Amending Directive, to the extent implemented in the Relevant Member State) and includes any relevant implementing measure in the Relevant Member State and the expression **"2010 PD Amending Directive"** means Directive 2010/73/EU.

United Kingdom

All applicable provisions of the Financial Services and Markets Act 2000 (as amended) (the "**FSMA**") must be complied with in respect of anything done in relation to any structured products in, from or otherwise involving the United Kingdom. An invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) may only be communicated or caused to be communicated in connection with the issue or sale of any structured products in circumstances in which Section 21(1) of the FSMA does not or where applicable would not, if we were not an authorised person, apply to us.

Hong Kong

No person, other than a person permitted to do so under the securities laws of Hong Kong, has issued or had in its possession for the purposes of issue, or will issue, or have in its possession for the purposes of issue any advertisement, invitation or document relating to the structured products, whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong other than with respect to structured products which are or are intended to be disposed of only to persons outside Hong Kong or only to "**professional investors**" within the meaning of the Securities and Futures Ordinance (Cap. 571) of the laws of Hong Kong and any rules made thereunder.

TAXATION

The comments below are of a general nature and are only a summary of the law and practice currently applicable under the relevant law. The comments relate to the position of persons who are the absolute beneficial owners of the structured products and may not apply equally to all persons. If you are in any doubt as to your tax position on purchase, ownership, transfer or exercise of any structured product, you should consult your own tax advisers.

HONG KONG

General

You may be required to pay stamp duties, taxes and other charges in accordance with the laws and practices of the country of purchase in addition to the issue price of each structured product.

Profits tax

No tax is payable in Hong Kong by way of withholding or otherwise in respect of dividends of any company or in respect of any capital gains arising on the sale of any shares or structured products, except that Hong Kong profits tax may be chargeable on any such gains in the case of certain persons carrying on a trade, profession or business in Hong Kong.

Stamp duty

Stamp duty is not chargeable on the transfer of purely cash settled structured products in Hong Kong.

Estate duty

No estate duty is payable on any payment under the structured products in Hong Kong.

UNITED STATES OF AMERICA

The following section on "U.S. Foreign Account Tax Compliance Act" is applicable to all investors. If you are uncertain about the tax consequences of investing in our structured products, you should consult your own tax adviser.

U.S. Foreign Account Tax Compliance Act

We and other financial institutions through which payments on the structured products are made may be required to withhold U.S. tax at a rate of 30 per cent. on all, or a portion of, payments made after the later of 31 December 2016 or the date on which final U.S. Treasury Regulations defining the term "foreign passthru payments" are filed with the U.S. Federal Register in respect of (i) any structured products characterised as debt (or which are not otherwise characterised as equity and have a stated expiration or term) for U.S. federal tax purposes that are issued after (or are materially modified after) the later of (x) 31 December 2013 or (y) six months after the date on which final U.S. Treasury Regulations defining the term "foreign passthru payments" are filed with the U.S. Federal Register and (ii) any structured products characterised as equity or which do not have a stated expiration or term for U.S. federal tax purposes, whenever issued, pursuant to Sections 1471 through 1474 of the U.S. Internal Revenue Code ("**FATCA**") or similar law implementing an intergovernmental approach to FATCA.

In addition, we and other financial institutions through which payments on the structured products are made may be required to withhold U.S. tax pursuant to FATCA at a rate of 30 per cent. on payments made after 31 December 2013 in respect of any structured products characterised as debt (or which are not otherwise characterised as equity and have a stated expiration or term) for U.S. federal tax purposes that are issued after six months after the date on which such products give rise to "dividend equivalent" payments as described below under "Legislation Affecting Dividend Equivalent Payments" or are materially modified from that date.

This withholding tax may apply to an investor or to any non-U.S. financial institution through which payment on the structured products is made if that investor or financial institution is not in compliance with FATCA. Structured product holders therefore may receive less settlement amount than expected. We are not required to pay any additional amounts with respect to amounts so withheld.

FATCA is particularly complex and its application is uncertain at this time. The application of FATCA to structured products issued after 31 December 2013 (or whenever issued, in the case of structured products characterised as equity or without a stated expiration or term for U.S. federal tax purposes) may be addressed in the relevant supplemental listing document or a supplement to this base listing document, as applicable.

Further information on FATCA may be found at www.irs.gov/businesses/corporations/ under the section headed "Foreign Account Tax Compliance Act (FATCA)". Any information appearing on such website does not form part of this base listing document.

The following section on "Legislation Affecting Dividend Equivalent Payments" is applicable to structured products that are linked to U.S. equities and to all investors of such structured products.

Legislation Affecting Dividend Equivalent Payments

The United States Hiring Incentives to Restore Employment Act (the "**Act**") treats a "dividend equivalent" payment as a dividend from sources within the United States. Under the Act, unless reduced by an applicable tax treaty with the United States, such payments generally would be subject to U.S. withholding tax. A "dividend equivalent" payment is (i) a substitute dividend payment made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, (ii) a payment made pursuant to a "specified notional principal contract" as defined in the U.S. Internal Revenue Code and Treasury Regulations that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and (iii) any other payment determined by the U.S. Internal Revenue Service (the "IRS") to be substantially similar to a payment described in the preceding clauses (i) and (ii). Under proposed U.S. Treasury Regulations, certain payments that are contingent upon or determined by reference to U.S. source dividends, including payments reflecting adjustments for extraordinary dividends, with respect to equity-linked instruments (including the structured products) may be treated as dividend equivalent payments. If enacted in their current form, the regulations will impose a withholding tax on payments made on the structured products on or after 1 January 2014 that are treated as dividend equivalent payments. In that case, we (or the applicable paying agent) would be entitled to withhold taxes without being required to pay any additional amounts with respect to taxes so withheld.

TO ENSURE COMPLIANCE WITH U.S. INTERNAL REVENUE SERVICE CIRCULAR 230, EACH TAXPAYER IS HEREBY NOTIFIED THAT: (A) ANY TAX DISCUSSION HEREIN IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED BY THE TAXPAYER FOR THE PURPOSE OF AVOIDING U.S. FEDERAL INCOME TAX PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER; (B) ANY SUCH TAX DISCUSSION WAS WRITTEN TO SUPPORT THE PROMOTION OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED HEREIN; AND (C) THE TAXPAYER SHOULD SEEK ADVICE BASED ON THE TAXPAYER'S PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISER.

Who is responsible for this base listing document?

We accept full responsibility for the accuracy of the information contained in this base listing document.

We have included references to websites to guide you to sources of freely available information. The information on these websites does not form part of our listing document. We do not accept any responsibility for the information on those websites. Such information has not been prepared for the purposes of our structured products. You should conduct your own web searches and consult publicly available information to ensure that you are viewing the most up-to-date information.

This base listing document is accurate at the date stated on the cover. You must not assume, however, that information in this base listing document is accurate at any time after the date of this base listing document.

The liquidity provider is not responsible in any way for ensuring the accuracy of our listing documents.

Is there any guarantee or collateral for the structured products?

No. Our obligations under the structured products are neither guaranteed by any third party, nor collateralised with any of our assets or other collaterals. When you purchase our structured products, you are relying on our creditworthiness only, and of no other person. If we become insolvent or default on our obligations under the structured products, you can only claim as an unsecured creditor of the Issuer. In such event, you may not be able to recover all or even part of the amount due under the structured products (if any).

Are we regulated by the Hong Kong Monetary Authority referred to in rule 15A.13(2) or the Securities and Futures Commission referred to in rule 15A.13(3)?

Other than being a licensed bank regulated by the Hong Kong Monetary Authority, a registered institution under the Securities and Futures Ordinance (Cap. 571) of Hong Kong to carry on type 1 (Dealing in Securities), type 2 (Dealing in Futures Contracts), type 4 (Advising on Securities), type 5 (Advising on Futures Contracts) and type 6 (Advising on Corporate Finance) regulated activities and a licensed bank under the Banking Ordinance (Cap. 155) of Hong Kong, we are not regulated by any of the bodies referred to in rule 15A.13(2) or (3) of the rules.

What are our credit ratings?

Our long-term debt ratings are:

Rating agency	**Rating as of the day immediately preceding the date of this base listing document**
Moody's Investors Service, Inc., New York	Aa2
Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc.	AA-

Rating agencies usually receive a fee from the companies that they rate. When evaluating our creditworthiness, you should not solely rely on our credit ratings because:

– a credit rating is not a recommendation to buy, sell or hold our structured products;

– ratings of companies may involve difficult-to-quantify factors such as market competition, the success or failure of new products and markets and managerial competence; and

– a high credit rating is not necessarily indicative of low risk. Our credit ratings as of the day immediately preceding the date of this document are for reference only. Any downgrading of our ratings could result in a reduction in the value of the structured products.

Our structured products are not rated.

Our credit ratings are subject to change or withdrawal at any time within each rating agency's sole discretion. You should conduct your own research using publicly available sources to obtain the latest information with respect to our ratings from time to time.

Are we subject to any litigation?

Except as set out in this base listing document, there are no legal or arbitration proceedings (including any such proceedings which are pending or threatened of which we are aware) which may have, or have had in the previous 12 months, a significant effect on us and our subsidiaries.

Has our financial position changed since last financial year?

Except as set out in this base listing document, there has been no material adverse change in our financial or trading position or prospects or indebtedness since 31 December 2012.

If, after the date of this document, you receive this document or purchase any structured products issued pursuant to this document you should not assume that there have been no changes in our affairs or financial condition since the date of this document. You should ask us if we have published any addenda to this document or any subsequent base listing document relating to our programme. Any such addenda will be available for inspection in the manner described under the section headed "*Where can you find out information about us?*" below.

Who is authorised to give information or make representations?

No person has been authorised to give any information or make any representations other than those contained in this document and the applicable supplemental listing document. If any person gives any such information or makes any such representations you should not rely on them as having been authorised by us.

Who are our authorised representatives?

Our authorised representatives are Keith Chan and Paul Hedley, both c/o The Hongkong and Shanghai Banking Corporation Limited, Level 16, HSBC Main Building, 1 Queen's Road Central, Hong Kong.

Who makes determinations and calculations?

We will make any necessary determinations or calculations in respect of the structured products.

Where can you find out information about us?

You can find out more about us on the website of the group of companies to which we belong, which is www.hsbc.com.

You may also inspect copies of the following documents at the office of The Hongkong and Shanghai Banking Corporation Limited during the period in which the structured products are listed on the stock exchange:

(a) a copy of this document and any addendum to this document (both the English version and the Chinese translation);

(b) a copy of our latest publicly available annual report and interim report (if any); and

(c) copies of the consent letters of our auditors referred to in this document.

Are there any experts/auditors involved?

Our auditors ("**Auditors**"), KPMG, have given and have not withdrawn their written consent to the inclusion of their report dated 4 March 2013 on the consolidated financial statements of the Issuer as of and for the year ended 31 December 2012, and/or references to their name in this base listing document, in the form and context in which they are included. Their report was not prepared exclusively for incorporation into this base listing document. The Auditors do not own any of our shares or shares in any member of our group, nor do they have the right (whether legally enforceable or not) to subscribe for or to nominate persons to subscribe for our securities or securities in any member of our group.

Do the stock exchange and the Securities and Futures Commission charge any fees?

The stock exchange charges a trading fee of 0.005 per cent. and the Securities and Futures Commission charges a transaction levy of 0.003 per cent. in respect of each transaction effected on the stock exchange payable by each of the seller and the buyer and calculated on the value of the consideration for the relevant securities. The levy for the investor compensation fund is currently suspended. Under the terms and conditions of the structured products, you are required to pay all charges arising on the transfer of underlying shares following the exercise of structured products.

Your broker may charge commission or other fees. You should check with your broker what fees will be chargeable.

You should be aware that you may be required to pay taxes including stamp taxes or other documentary charges in accordance with the laws and practices of the country where the structured products are transferred, or where the issuer of the underlying asset is organised or resident. If you are in any doubt as to your tax position, you should consult your own independent tax advisers. You should also be aware that tax regulations and their application by the relevant taxation authorities change from time to time.

How are the structured products transferred and settled?

Settlement of transactions between members of the stock exchange on any business day must take place on or before the second business day thereafter. Securities executed on the stock exchange would normally be settled under the continuous net settlement system in CCASS.

Dealings in the structured products will take place in relevant board lots in the relevant settlement currency. For further details on transfers of structured products and their exercise, termination pursuant to mandatory call event or settlement, you should refer to the terms and conditions of the relevant issue of structured products.

EXHIBIT A

CONSOLIDATED FINANCIAL STATEMENTS OF THE ISSUER AS AT AND FOR THE YEARS ENDED 31 DECEMBER 2011 AND 31 DECEMBER 2012

The information in this Exhibit A has been extracted from the Annual Report and Accounts 2012 of the Issuer. References to page numbers (i.e. the page numbers which appear on the bottom of the pages) in this Exhibit A are to pages of the Annual Report and Accounts 2012. The extracts set out in this Exhibit A are not complete and reference should be made to the Annual Report and Accounts 2012 which is available for inspection at the office of The Hongkong and Shanghai Banking Corporation Limited, HSBC Main Building, 1 Queen's Road Central, Hong Kong.

Independent auditor's report to the shareholders of The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong with limited liability)

We have audited the consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') set out on pages 31 to 200, which comprise the consolidated and the Bank's balance sheets as at 31 December 2012, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated and the Bank's 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 as to 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 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 the affairs of the Bank and the group as at 31 December 2012 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

4 March 2013

Financial Statements

Financial Statements (continued)

Consolidated income statement for the year ended 31 December 2012

	Note	2012 HK$m	2011 HK$m
Interest income	4a	115,511	107,458
Interest expense	4b	(33,092)	(31,786)
Net interest income		82,419	75,672
Fee income		46,221	45,166
Fee expense		(6,331)	(6,871)
Net fee income	4c	39,890	38,295
Net trading income	4d	19,214	20,199
Net income / (expense) from financial instruments designated at fair value	4e	4,613	(4,523)
Gains less losses from financial investments	4f	2,634	128
Dividend income	4g	522	729
Net earned insurance premiums	5b	52,621	45,670
Other operating income	4h	15,337	11,389
Total operating income		217,250	187,559
Net insurance claims incurred and movement in liabilities to policyholders	5c	(54,983)	(40,389)
Net operating income before loan impairment charges and other credit risk provisions		162,267	147,170
Loan impairment charges and other credit risk provisions	4i	(3,578)	(3,059)
Net operating income		158,689	144,111
Employee compensation and benefits	6a	(37,021)	(37,834)
General and administrative expenses	4j	(26,011)	(24,352)
Depreciation of property, plant and equipment	26	(4,014)	(3,878)
Amortisation and impairment of intangible assets	25c	(1,724)	(1,760)
Total operating expenses		(68,770)	(67,824)
Operating profit		89,919	76,287
Share of profit in associates and joint ventures		18,810	15,083
Profit before tax		108,729	91,370
Tax expense	7	(18,010)	(17,466)
Profit for the year		90,719	73,904
Profit attributable to shareholders		83,008	67,591
Profit attributable to non-controlling interests		7,711	6,313

Consolidated statement of comprehensive income for the year ended 31 December 2012

	2012 HK$m	2011 HK$m
Profit for the year	**90,719**	73,904
Other comprehensive income		
Available-for-sale investments:		
– fair value changes taken to equity	**14,153**	(25,410)
– fair value changes transferred to the income statement on disposal	**(2,753)**	(231)
– amounts transferred to the income statement on (impairment)/ reversal of impairment	**5**	(208)
– fair value changes transferred to the income statement on hedged items due to hedged risk	**(287)**	(1,124)
– income taxes	**(768)**	119
Cash flow hedges:		
– fair value changes taken to equity	**3,858**	303
– fair value changes transferred to the income statement	**(3,662)**	(399)
– income taxes	**(33)**	15
Property revaluation:		
– fair value changes taken to equity	**7,221**	12,940
– income taxes	**(1,161)**	(2,068)
Share of other comprehensive income / (expense) of associates and joint ventures	**638**	(1,259)
Exchange differences	**925**	(1,235)
Actuarial gains / (losses) on post-employment benefits:		
– before income taxes	**1,080**	(3,518)
– income taxes	**(198)**	575
Other comprehensive income / (expense) for the year, net of tax	**19,018**	(21,500)
Total comprehensive income for the year, net of tax	**109,737**	52,404
Total comprehensive income for the year attributable to:		
– shareholders	**100,814**	45,428
– non-controlling interests	**8,923**	6,976
	109,737	52,404

Financial Statements (continued)

Consolidated balance sheet at 31 December 2012

	Note	2012 HK$m	2011 HK$m
ASSETS			
Cash and short-term funds	11	**1,111,199**	919,906
Items in the course of collection from other banks		**23,079**	34,546
Placings with banks maturing after one month	12	**184,711**	198,287
Certificates of deposit	13	**93,085**	88,691
Hong Kong Government certificates of indebtedness	14	**176,264**	162,524
Trading assets	15	**419,697**	447,968
Financial assets designated at fair value	16	**69,479**	57,670
Derivatives	17	**398,956**	377,296
Loans and advances to customers	18	**2,349,043**	2,130,871
Financial investments	21	**626,042**	722,433
Amounts due from Group companies		**176,004**	152,730
Interests in associates and joint ventures	24	**119,273**	91,785
Goodwill and intangible assets	25	**38,634**	34,839
Property, plant and equipment	26	**90,179**	85,294
Deferred tax assets	7	**2,629**	2,325
Other assets	28	**187,053**	100,315
Total assets		**6,065,327**	5,607,480
LIABILITIES			
Hong Kong currency notes in circulation	14	**176,264**	162,524
Items in the course of transmission to other banks		**35,525**	47,163
Deposits by banks		**244,135**	222,582
Customer accounts	29	**3,874,884**	3,565,001
Trading liabilities	30	**183,340**	171,431
Financial liabilities designated at fair value	31	**44,270**	40,392
Derivatives	17	**397,151**	383,252
Debt securities in issue	32	**74,647**	77,472
Retirement benefit liabilities	6	**6,725**	8,097
Amounts due to Group companies		**97,618**	108,423
Other liabilities and provisions	33	**94,791**	108,314
Liabilities under insurance contracts issued	34	**244,921**	209,438
Current tax liabilities	7	**3,842**	4,126
Deferred tax liabilities	7	**16,923**	14,712
Subordinated liabilities	36	**13,867**	16,114
Preference shares	37	**83,346**	97,096
Total liabilities		**5,592,249**	5,236,137
EQUITY			
Share capital	38	**58,969**	30,190
Other reserves		**133,790**	112,218
Retained profits		**224,640**	188,416
Proposed fourth interim dividend	9	**20,000**	10,000
Total shareholders' equity		**437,399**	340,824
Non-controlling interests		**35,679**	30,519
Total equity		**473,078**	371,343
Total equity and liabilities		**6,065,327**	5,607,480

Directors
Stuart T Gulliver
Rose W M Lee
Peter T S Wong

Secretary
Paul A Stafford

Consolidated statement of changes in equity for the year ended 31 December 2012

	2012									
			Other reserves							
	Share capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve HK$m	Available-for-sale investment reserve HK$m	Cash flow hedge reserve HK$m	Foreign exchange reserve HK$m	Other HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	30,190	198,416	38,939	29,786	51	14,265	29,177	340,824	30,519	371,343
Profit for the year	–	83,008	–	–	–	–	–	83,008	7,711	90,719
Other comprehensive income (net of tax)	–	519	5,522	10,788	159	928	(110)	17,806	1,212	19,018
Available-for-sale investments	–	–	–	10,040	–	–	–	10,040	310	10,350
Cash flow hedges	–	–	–	–	159	–	–	159	4	163
Property revaluation	–	(168)	5,522	–	–	–	–	5,354	706	6,060
Actuarial gains on defined benefit plans	–	689	–	–	–	–	–	689	193	882
Share of other comprehensive income of associates and joint ventures	–	(1)	–	749	–	–	(110)	638	–	638
Exchange differences	–	(1)	–	(1)	–	928	–	926	(1)	925
Total comprehensive income for the year	–	83,527	5,522	10,788	159	928	(110)	100,814	8,923	109,737
Shares issued	28,779	–	–	–	–	–	–	28,779	–	28,779
Dividends paid	–	(32,500)	–	–	–	–	–	(32,500)	(3,766)	(36,266)
Movement in respect of share-based payment arrangements	–	(246)	–	–	–	–	(277)	(523)	14	(509)
Other movements	–	(3)	–	8	–	–	–	5	(11)	(6)
Transfers	–	(4,554)	(1,010)	(2)	–	–	5,566	–	–	–
At 31 December	58,969	244,640	43,451	40,580	210	15,193	34,356	437,399	35,679	473,078

Financial Statements (continued)

Consolidated statement of changes in equity for the year ended 31 December 2012 *(continued)*

	2011									
			Other reserves							
	Share capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve HK$m	Available-for-sale investment reserve HK$m	Cash flow hedge reserve HK$m	Foreign exchange reserve HK$m	Other HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	22,494	173,254	29,980	57,553	106	15,789	20,954	320,130	27,305	347,435
Profit for the year	–	67,591	–	–	–	–	–	67,591	6,313	73,904
Other comprehensive income (net of tax)	–	(2,578)	9,828	(27,760)	(55)	(1,524)	(74)	(22,163)	663	(21,500)
Available-for-sale investments	–	–	–	(26,579)	–	–	–	(26,579)	(275)	(26,854)
Cash flow hedges	–	–	–	–	(56)	–	–	(56)	(25)	(81)
Property revaluation	–	(137)	9,828	–	–	–	–	9,691	1,181	10,872
Actuarial losses on defined benefit plans	–	(2,437)	–	–	–	–	–	(2,437)	(506)	(2,943)
Share of other comprehensive income of associates and joint ventures	–	(6)	–	(1,181)	–	–	(72)	(1,259)	–	(1,259)
Exchange differences	–	2	–	–	1	(1,524)	(2)	(1,523)	288	(1,235)
Total comprehensive income for the year	–	65,013	9,828	(27,760)	(55)	(1,524)	(74)	45,428	6,976	52,404
Shares issued	7,696	–	–	–	–	–	–	7,696	–	7,696
Dividends paid	–	(33,000)	–	–	–	–	–	(33,000)	(3,764)	(36,764)
Movement in respect of share-based payment arrangements	–	91	–	–	–	–	694	785	26	811
Other movements	–	(3)	–	(7)	–	–	(205)	(215)	(24)	(239)
Transfers	–	(6,939)	(869)	–	–	–	7,808	–	–	–
At 31 December	30,190	198,416	38,939	29,786	51	14,265	29,177	340,824	30,519	371,343

Consolidated statement of cash flows for the year ended 31 December 2012

	Note	2012 HK$m	2011 HK$m
Operating activities			
Cash (used in)/generated from operations	42	**(20,651)**	16,583
Interest received on financial investments		**14,349**	13,269
Dividends received on financial investments		**464**	723
Dividends received from associates		**2,297**	935
Taxation paid		**(17,423)**	(15,790)
Net cash (outflow)/inflow from operating activities		**(20,964)**	15,720
Investing activities			
Purchase of financial investments		**(262,280)**	(495,823)
Proceeds from sale or redemption of financial investments		**350,945**	588,409
Purchase of property, plant and equipment		**(1,990)**	(2,870)
Proceeds from sale of property, plant and equipment and assets held for sale		**35**	215
Purchase of other intangible assets		**(1,303)**	(1,804)
Net cash outflow in respect of the acquisition of and increased shareholding in subsidiaries	43	**–**	(143)
Net cash inflow in respect of the sale of subsidiaries	43	**1,416**	1
Net cash outflow in respect of the purchase of interests in associates and joint ventures		**(13,521)**	(263)
Net cash (outflow)/inflow from the sale of interests in business portfolios	43	**(12,242)**	5,649
Proceeds from the sale of interests in associates	43	**3,970**	19
Net cash inflow from investing activities		**65,030**	93,390
Net cash inflow before financing		**44,066**	109,110
Financing			
Issue of ordinary share capital		**28,779**	7,696
Issue of preference shares		**29**	–
Redemption of preference shares		**(13,566)**	(4,280)
Repayment of subordinated liabilities		**(2,326)**	(5,152)
Issue of subordinated liabilities		**2,328**	3,502
Ordinary dividends paid	9	**(32,500)**	(33,000)
Dividends paid to non-controlling interests		**(3,766)**	(3,764)
Interest paid on preference shares		**(2,301)**	(2,421)
Interest paid on subordinated liabilities		**(884)**	(793)
Net cash outflow from financing		**(24,207)**	(38,212)
Increase in cash and cash equivalents	43	**19,859**	70,898

Financial Statements (continued)

Bank balance sheet at 31 December 2012

	Note	2012 HK$m	2011 HK$m
ASSETS			
Cash and short-term funds	11	**761,187**	612,265
Items in the course of collection from other banks		**17,355**	29,821
Placings with banks maturing after one month	12	**80,200**	108,873
Certificates of deposit	13	**20,150**	23,987
Hong Kong Government certificates of indebtedness	14	**176,264**	162,524
Trading assets	15	**284,573**	317,321
Financial assets designated at fair value	16	**1,432**	2,283
Derivatives	17	**391,839**	370,678
Loans and advances to customers	18	**1,282,720**	1,176,602
Financial investments	21	**260,317**	362,307
Amounts due from Group companies		**321,600**	248,001
Investments in subsidiaries	23	**58,819**	57,724
Interests in associates and joint ventures	24	**40,919**	28,139
Goodwill and intangible assets	25	**4,765**	4,831
Property, plant and equipment	26	**53,852**	51,876
Deferred tax assets	7	**1,333**	1,098
Other assets	28	**143,480**	57,011
Total assets		**3,900,805**	3,615,341
LIABILITIES			
Hong Kong currency notes in circulation	14	**176,264**	162,524
Items in the course of transmission to other banks		**25,766**	38,577
Deposits by banks		**204,520**	158,746
Customer accounts	29	**2,417,400**	2,220,072
Trading liabilities	30	**82,146**	78,959
Financial liabilities designated at fair value	31	**7,731**	5,910
Derivatives	17	**392,084**	377,165
Debt securities in issue	32	**40,406**	46,360
Retirement benefit liabilities	6	**3,710**	4,150
Amounts due to Group companies		**149,237**	152,906
Other liabilities and provisions	33	**58,887**	71,585
Current tax liabilities	7	**2,348**	2,748
Deferred tax liabilities	7	**6,194**	5,884
Subordinated liabilities	36	**9,355**	9,386
Preference shares	37	**83,195**	96,969
Total liabilities		**3,659,243**	3,431,941
EQUITY			
Share capital	38	**58,969**	30,190
Other reserves		**62,219**	49,278
Retained profits		**100,374**	93,932
Proposed fourth interim dividend	9	**20,000**	10,000
Total equity		**241,562**	183,400
Total equity and liabilities		**3,900,805**	3,615,341

Directors
Stuart T Gulliver
Rose W M Lee
Peter T S Wong

Secretary
Paul A Stafford

Bank statement of changes in equity for the year ended 31 December 2012

	2012							
			Other reserves					
	Share capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve HK$m	Available-for-sale investment reserve HK$m	Cash flow hedge reserve HK$m	Foreign exchange reserve HK$m	Other HK$m	Total equity HK$m
At 1 January	30,190	103,932	24,296	26,013	63	(3,152)	2,058	183,400
Profit for the year	–	48,377	–	–	–	–	–	48,377
Other comprehensive income (net of tax)	–	224	3,142	10,105	157	368	–	13,996
Available-for-sale investments	–	–	–	10,106	–	–	–	10,106
Cash flow hedges	–	–	–	–	157	–	–	157
Property revaluation	–	(97)	3,142	–	–	–	–	3,045
Actuarial gains on defined benefit plans	–	321	–	–	–	–	–	321
Exchange differences	–	–	–	(1)	–	368	–	367
Total comprehensive income	–	48,601	3,142	10,105	157	368	–	62,373
Shares issued	28,779	–	–	–	–	–	–	28,779
Dividends paid	–	(32,500)	–	–	–	–	–	(32,500)
Movement in respect of share-based payment arrangements	–	(221)	–	–	–	–	(269)	(490)
Other movements	–	–	–	–	–	–	–	–
Transfers	–	562	(562)	–	–	–	–	–
At 31 December	58,969	120,374	26,876	36,118	220	(2,784)	1,789	241,562

Bank statement of changes in equity for the year ended 31 December 2012 *(continued)*

	2011							
			Other reserves					
	Share Capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve HK$m	Available-for-sale investment reserve HK$m	Cash flow hedge reserve HK$m	Foreign exchange reserve HK$m	Other HK$m	Total equity HK$m
At 1 January	22,494	100,086	18,437	50,551	70	1,304	1,567	194,509
Profit for the year	–	37,812	–	–	–	–	–	37,812
Other comprehensive income (net of tax)	–	(1,533)	6,378	(24,538)	(7)	(4,456)	–	(24,156)
Available-for-sale investments	–	–	–	(24,538)	–	–	–	(24,538)
Cash flow hedges	–	–	–	–	(7)	–	–	(7)
Property revaluation	–	(79)	6,378	–	–	–	–	6,299
Actuarial losses on defined benefit plans	–	(1,454)	–	–	–	–	–	(1,454)
Exchange differences	–	–	–	–	–	(4,456)	–	(4,456)
Total comprehensive income	–	36,279	6,378	(24,538)	(7)	(4,456)	–	13,656
Shares issued	7,696	–	–	–	–	–	–	7,696
Dividends paid	–	(33,000)	–	–	–	–	–	(33,000)
Movement in respect of share-based payment arrangements	–	52	–	–	–	–	551	603
Other movements	–	(4)	–	–	–	–	(60)	(64)
Transfers	–	519	(519)	–	–	–	–	–
At 31 December	30,190	103,932	24,296	26,013	63	(3,152)	2,058	183,400

Notes on the Financial Statements

1 Basis of preparation

a The consolidated financial statements comprise the accounts of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries ('the group') as of 31 December 2012.

The consolidated financial statements have been prepared in accordance with Hong Kong Financial Reporting Standards ('HKFRSs'), the provisions of the Hong Kong Companies Ordinance and accounting principles generally accepted in Hong Kong. HKFRSs is a collective term which includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ('HKASs') and Interpretations issued by the Hong Kong Institute of Certified Public Accountants ('HKICPA').

The consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of certain financial assets and liabilities, premises, and certain assets and liabilities related to insurance contracts.

During 2012 the group adopted a number of interpretations and amendments to standards, all of which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of the Bank.

Following the amendment to HKAS 12 'Income Taxes' issued by the HKICPA in December 2010, deferred taxes on investment property, carried under the fair value model in HKAS 40, are measured based on the rebuttable presumption that an investment property is recovered entirely through sale. The application of the amendment to HKAS 12 did not have a material effect on the group's consolidated financial statements and, consequently, has been applied prospectively.

b The consolidated financial statements include the attributable share of the results and reserves of associates and joint ventures based on accounts prepared at dates not earlier than three months prior to 31 December 2012.

c Future Accounting Developments

At 31 December 2012, a number of standards and interpretations, and amendments thereto, had been issued by the HKICPA, which are not effective for the group's consolidated financial statements as at 31 December 2012. In addition to the projects to complete financial instrument accounting, there are other projects on insurance, revenue recognition and lease accounting which, together with the standards described below, will represent significant changes to accounting requirements from 2015 and later.

Standards applicable in 2013

In June 2011, the HKICPA issued HKFRS 10 'Consolidated Financial Statements' ('HKFRS 10'), HKFRS 11 'Joint Arrangements' ('HKFRS 11') and HKFRS 12 'Disclosure of Interests in Other Entities' ('HKFRS 12'). In July 2012, HKICPA issued amendments to HKFRS 10, HKFRS 11 and HKFRS 12 'Transition Guidance'. The standards are effective for annual periods beginning on or after 1 January 2013. HKFRSs 10 and 11 are to be applied retrospectively.

Under HKFRS 10, there will be one approach for determining consolidation for all entities, based on the concept of power, variability of returns and their linkage. This will replace the current approach which emphasises legal control or exposure to risks and rewards, depending on the nature of the entity. HKFRS 11 places more focus on the investors' rights and obligations than on the structure of an arrangement, and introduces the concept of a joint operation. HKFRS 12 includes the disclosure requirements for subsidiaries, joint arrangements and associates and introduces new requirements for unconsolidated structured entities.

Based on our assessment to date, while the consolidation status of some entities may change because the group has control but not the majority of risks and rewards, or vice versa, we do not expect the overall impact of HKFRS 10 and HKFRS 11 on the financial statements to be material.

In June 2011, the HKICPA issued HKFRS 13 'Fair Value Measurement' ('HKFRS 13'). This standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. HKFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of HKFRS 13 do not require comparative information to be provided for periods prior to initial application.

Notes on the Financial Statements (continued)

1 Basis of preparation *(continued)*

HKFRS 13 establishes a single source of guidance for all fair value measurements required or permitted by HKFRSs. The standard clarifies the definition of fair value as an exit price, which is defined as a price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions, and enhances disclosures about fair value measurement.

Based on our current assessment, we do not expect the impact of HKFRS 13 on the financial statements to be material.

In July 2011, the HKICPA issued amendments to HKAS 19 'Employee Benefits' ('HKAS 19 revised'). The revised standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. HKAS 19 revised is to be applied retrospectively.

The most significant amendment for the group is 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 effect of this change is to increase the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

Based on our estimate of the impact of this particular amendment on the 2012 consolidated financial statements, the change would decrease pre-tax profit, with no effect on the pension liability. The effect on total operating expenses and pre-tax profit is not material. The effect at the date of adoption on 1 January 2013 was not material to the group.

In December 2011, the HKICPA issued amendments to HKFRS 7 'Disclosures – Offsetting Financial Assets and Financial Liabilities' which requires disclosures about the effect or potential effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. The amendments are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendments are required to be applied retrospectively.

Standards applicable in 2014

In December 2011, the HKICPA issued amendments to HKAS 32 'Financial Instruments: Presentation' which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in HKAS 32. 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.

The group is currently assessing the impact of these clarifications but it is not practical to quantify their effect as at the date of publication of these consolidated financial statements.

In December 2012, HKICPA issued amendments to HKFRS 10, HKFRS 12 and HKAS 27, which introduced an exception for investment entities to the principle that all subsidiaries shall be consolidated. We do not expect the amendments to have any material impact on the group's financial statements.

Standards applicable in 2015

In November 2009, the HKICPA issued HKFRS 9 'Financial Instruments' ('HKFRS 9') which introduced new requirements for the classification and measurement of financial assets. In November 2010, the HKICPA issued an amendment to HKFRS 9 incorporating requirements for financial liabilities. Together, these changes represent the first phase in the planned replacement of HKAS 39 'Financial Instruments: Recognition and Measurement' ('HKAS 39').

Following the HKICPA's decision in December 2011 to defer the effective date, the standard is effective for annual periods beginning on or after 1 January 2015.

The second and third phases in the HKAS 39 replacement project will address the impairment of financial assets measured at amortised cost and hedge accounting.

1 Basis of preparation *(continued)*

As a result of 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 it remains impracticable to quantify the effect of HKFRS 9 as at the date of the publication of these financial statements.

Enhanced Disclosure Task Force

In accordance with the group's policy to provide meaningful disclosures that help stakeholders understand the group's performance, financial position and changes thereto, the group intends to implement the recommendations of the Enhanced Disclosure Task Force ('EDTF') report 'Enhancing the Risk Disclosures of Banks' (issued on 29 October 2012), which are relevant. The EDTF was established in May 2012 at the initiative of the Financial Stability Board. Its objective was to develop recommendations for enhancing risk and regulatory disclosures by banks. The report's recommendations are voluntary and help financial institutions identify areas that need better and more transparent information about risks and how these relate to performance measurement and reporting.

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 our consolidated financial statements. The significant 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.

Loan impairment

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 that is recorded.

For collectively assessed loans, judgement is involved in selecting and applying the criteria for grouping together loans with similar credit characteristics, as well as in selecting and applying the statistical and other models used to estimate the losses incurred for each group of loans in the reporting period. The benchmarking of loss rates, the assessment of the extent to which historical losses are representative of current conditions and the ongoing refinement of modelling methodologies provide a means of identifying changes that may be required, but the process is inherently one of estimation.

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 17 'Derivatives' and note 51 'Fair value of financial instruments'.

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

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

Notes on the Financial Statements (continued)

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

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 account of factors such as bid-offer spread, credit profile, model uncertainty 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 have 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 removed from equity and recognised in the income statement, reducing the group's operating profit.

Impairment of interests in associates

The group's accounting policy for impairment of interests in associates is set out in note 3m. When an investment in an associate is tested in accordance with HKAS 36 'Impairment of Assets' to determine whether it is impaired, significant judgement is required in selecting and applying appropriate assumptions and estimates to determine the recoverable amount.

Liabilities under investment contracts

Estimating the liabilities for long-term investment contracts where the group has guaranteed a minimum return involves the use of statistical techniques. The selection of these techniques and the assumptions used about future interest rates and rates of return on equities, as well as behavioural and other future events, have a significant impact on the amount recognised as a liability.

Insurance contracts

Classification

HKFRS 4 'Insurance Contracts' 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 25(b). 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 note 52.

3 Summary of significant accounting policies

a *Interest income and expense*

Interest income and expense for all financial instruments, except those classified as held for trading or designated at fair value (other than debt securities issued by the group and derivatives managed in conjunction with such debt securities issued) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

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.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

b *Non interest income*

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is 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 as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- 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 recorded in 'Interest income' (Note 3(a)).

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with the related interest income, expense and dividends.

Net income from financial instruments designated at fair value includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on these financial instruments are also included, except for interest arising from debt securities issued, and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense' (Note 3(a)).

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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

c *Loans and advances to customers and placings with banks*

Loans and advances to customers and placings with banks include loans and advances originated by the group which are not classified as either held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to a borrower. They are derecognised when either the borrower repays its obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less any reduction from impairment or uncollectibility. Where exposures are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

Loans and advances are reclassified to held for sale when their carrying amounts are to be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable (Note 3ac); however, such loans and advances continue to be measured in accordance with the policy described above.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of the group. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative and measured at fair value through profit or loss. On drawdown, the loan is classified as held for trading and measured at fair value through profit or loss. Where it is not the group's intention to trade but hold the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception of the loan, the loan to be held is recorded at its fair value and subsequently measured at amortised cost using the effective interest method. For certain transactions, such as leveraged finance and syndicated lending activities, the cash advanced is not necessarily the best evidence of the fair value of the loan. For these loans, where the initial fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write-down is charged to the income statement. The write-down will be recovered over the life of the loan, through the recognition of interest income using the effective interest method, unless the loan becomes impaired. The write-down is recorded as a reduction to other operating income.

Financial assets which have been reclassified into the loans and receivables category are initially recorded at the fair value at the date of reclassification and are subsequently measured at amortised cost, using the effective interest rate determined at the date of reclassification.

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d *Impairment of loans and advances*

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 calculated on individual loans and on groups of loans assessed collectively. Impairment losses are recorded as charges to the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of impairment allowance accounts. Losses expected from future events are not recognised.

Individually assessed loans and advances

The factors considered in determining that a loan is individually significant for the purposes of assessing impairment include:

- the size of the loan;
- the number of loans in the portfolio;
- the importance of the individual loan relationship, and how this is managed; and
- whether volumes of defaults and losses are sufficient to enable a collective assessment methodology to be applied.

Loans considered as individually significant are typically to corporate and commercial customers, are for larger amounts and are managed on an individual relationship basis. Retail lending portfolios are generally assessed for impairment on a collective basis as the portfolios generally consist of large pools of homogeneous loans.

3 Summary of significant accounting policies *(continued)*

For all loans that are considered individually significant, the group assesses on a case-by-case basis at each balance sheet date 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 being past due for more than 90 days;
- the probability that the borrower will enter bankruptcy or other financial realisation;
- 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
- deterioration in the financial condition or outlook of the borrower such that the ability to repay is considered doubtful.

For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service 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 company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

The realisable value of security is determined based on the current market value when the impairment assessment is performed. The value is not adjusted for expected future changes in market prices; however, adjustments are made to reflect local conditions, such as forced sale discounts.

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.

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

- 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 on loans subject to individual assessment.

3 Summary of significant accounting policies *(continued)*

Homogeneous groups of loans and advances

Statistical methods are used to determine impairment losses on a collective basis for homogeneous groups of loans that are not considered individually significant, because individual loan assessment is impracticable.

Losses in these groups of loans are recorded on an individual basis when individual loans are written off, at which point they are removed from the group. Two alternative methods are used to calculate allowances on a collective basis:

- when appropriate empirical information is available, the group uses a roll rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the 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. Under this methodology, loans are grouped into ranges according to the number of days past due and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency, and ultimately prove irrecoverable. In addition to the delinquency groupings, loans are segmented according to their credit characteristics as described below. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, the group adopts a basic formulaic approach based on historical loss rate experience.

The inherent loss within each portfolio is assessed on the basis of statistical models using historical data observations, which are updated periodically to reflect recent portfolio and economic trends. When the most recent trends in portfolio risk factors arising from changes in economic, regulatory or behavioural conditions are not fully reflected in the statistical models, they are taken into account by adjusting the impairment allowances derived solely from historical loss experience to reflect these changes as at the balance sheet date.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

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

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. The credit risk characteristics may include country of origination, type of business involved, type of products offered, security obtained or other relevant factors. 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.

3 Summary of significant accounting policies *(continued)*

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgment as to whether 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.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. As it is assessed empirically on a periodic basis the estimated period between a loss occurring and its identification may vary over time as these factors change.

Write-off of loans and advances

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 security. 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.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets' if the carrying amounts of the assets are recovered principally through sale, the assets are available for sale in their present condition and their 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 charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included within 'Other operating income' in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised as a gain in 'Other operating income' in the income statement, together with any realised gains or losses on disposal. Debt securities or equities acquired in debt-to-debt/equity swaps are included in 'Financial investments' and are classified as available-for-sale.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as up to date loans for measurement purposes, once the minimum number of payments required under the new arrangements has been received. Loans subject to collective impairment assessment whose terms have been renegotiated 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 of loans that have been classified as renegotiated retain this classification until maturity or derecognition.

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

e *Trading assets and trading liabilities*

Treasury bills, loans and advances to and from customers, loans and advances to and from banks, debt securities, structured deposits, equity shares, own debt issued and short positions in securities which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, are classified as held for trading. Financial assets and financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell the financial instruments, 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 trading income'.

f *Financial instruments designated at fair value*

Financial instruments, other than those held for trading, are classified in this category if they meet the criteria set out below and are so designated by management on initial recognition. The group may designate financial instruments at fair value 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; examples include unit-linked investment contracts, and certain portfolios of securities and debt issuances that are managed in conjunction with financial assets or liabilities measured on a fair value basis;
- applies to a group of financial assets, financial liabilities, or both, that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to key management personnel; examples include financial assets held to back certain insurance contracts, and certain asset-backed securities; or
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, and which would otherwise be required to be accounted for separately; examples include certain debt issuances and debt securities held.

This fair value designation, once made, is irrevocable. Financial assets and financial liabilities are recognised when the group enters 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*

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

3 Summary of significant accounting policies *(continued)*

Available-for-sale

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

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

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset. 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 and can be reliably estimated.

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

Impairment losses for available-for-sale debt securities are recognised within 'Loan impairment charges and other credit risk provisions' in the income statement and impairment losses for available-for-sale equity securities are recognised within 'Gains less losses from financial investments' in the income statement. The impairment methodologies for available-for-sale financial assets are set out in more detail below.

Available-for-sale debt securities

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.

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.

3 Summary of significant accounting policies *(continued)*

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

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if, there is objective evidence of impairment 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 directly in other comprehensive income. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value;
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses recognised on an equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost, less cumulative impairment to date, of the equity security.

Held-to-maturity investments

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

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 51.

i *Sale and repurchase agreements (including stock lending and borrowing)*

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to re-sell ('reverse repos') are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to customers' or 'Placings with banks' as appropriate. The difference between the sale and repurchase price is treated as interest income 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.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in 'Net trading income'.

3 Summary of significant accounting policies *(continued)*

j *Derivative financial instruments and hedge accounting*

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 and losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of a net investment in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment 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. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, 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 the 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.

3 Summary of significant accounting policies *(continued)*

Cash flow hedge

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

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. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously recognised in other comprehensive income are removed from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in other comprehensive income at that time remains in equity until the forecast transaction is eventually 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.

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses previously recognised in other comprehensive income are reclassified to the income statement on the disposal of the foreign operation.

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.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted by an entity to assess hedge effectiveness will depend on the risk management strategy.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness, the changes in fair value or cash flows must offset each other in the range of 80% to 125%.

Hedge ineffectiveness is recognised in the income statement in “Net trading income’.

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 ‘Net trading income’, except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in ‘Net income from financial instruments designated at fair value’. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in ‘Interest expense’. All other gains and losses on these derivatives are reported in ‘Net income from financial instruments designated at fair value’.

3 Summary of significant accounting policies *(continued)*

k *Derecognition of financial assets and liabilities*

Financial assets are derecognised when the rights to receive cash flows from the assets have expired; or where the group has transferred its contractual rights to receive the cash flows of the financial assets and has transferred substantially all the risks and rewards of ownership; or where both control and substantially all the risks and rewards are not retained.

Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged or cancelled or expires.

l *Offsetting financial assets and financial liabilities*

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

m *Subsidiaries, associates and joint ventures*

The group classifies investments in entities which it controls as subsidiaries. Where the group is a party to a contractual arrangement whereby, together with one or more parties, it undertakes an economic activity that is subject to joint control, the group classifies its interest in the venture as a joint venture. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates. For the purpose of determining this classification, control is considered to be the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Investments in associates and interests in joint ventures are 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 and joint ventures are eliminated to the extent of the group's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of the group's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

The Bank's investments in subsidiaries, associates and joint ventures 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.

In order to determine whether an impairment test under HKAS 36 'Impairment of Assets' is required in respect of an interest in an associate or a joint venture, 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 or joint venture 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(n). In the case of an interest in an associate or joint venture, 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.

3 Summary of significant accounting policies *(continued)*

n *Goodwill and intangible assets*

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

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

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 amount of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of its fair value less cost to sell, and its value in use. Value in use is the present value of the expected future cash flows from a 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 accumulated impairment losses, if any.

Goodwill on acquisitions of interests in joint ventures and associates is included in 'Interests in associates and joint ventures' and is not tested separately for impairment.

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.

Goodwill is included in a disposal group if the disposal group is a CGU to which goodwill has been allocated or it is an operation within such a CGU. The amount of goodwill included in a disposal group is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained.

(ii) Intangible assets include the present value of in-force long-term insurance business, operating rights, computer software and, when acquired in a business combination, trade names, customer relationships and core deposit relationships. Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually.

Intangible assets that have a finite useful life, except for the present value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected economic life.

Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

The accounting policy on the present value of in-force long-term insurance business is set out in note 3(w).

3 Summary of significant accounting policies *(continued)*

o *Property, plant and equipment*

(i) Land and buildings

Land and buildings held for own use are carried at their revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses.

Revaluations are performed by professional qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value. Surpluses arising on revaluation are credited firstly to the income statement, to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same land and buildings, and are thereafter taken to the ‘Property revaluation reserve’. Deficits arising on revaluation are first set off against any previous revaluation surpluses included in the ‘Property revaluation reserve’ in respect of the same land and buildings, and are thereafter recognised in the income statement.

Buildings held for own use which are situated on leasehold land where it is possible reliably to separate the value of the building from the value of the leasehold land at inception of the lease are revalued by professional qualified valuers, on a depreciated replacement cost basis or surrender value, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value.

Depreciation on land and buildings is calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;
- leasehold land is depreciated over the unexpired terms of the leases; and
- buildings and improvements thereto are depreciated at the greater of 2% per annum on the straight line basis or over the unexpired terms of the leases or over the remaining useful lives of the buildings.

(ii) Investment properties

The group holds certain properties as investments to earn rentals, or for capital appreciation, or both. Investment properties are stated at fair value with changes in fair value being recognised in ‘Other operating income’. Fair values are determined by independent professional valuers, primarily on the basis of capitalisation of net incomes with due allowance for outgoings and reversionary income potential. Property interests which are held under operating leases to earn rentals, or for capital appreciation, or both, are classified and accounted for as investment properties on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 3(p)).

(iii) Leasehold land and land use rights

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 interests in leasehold land and land use rights 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.

(iv) Other plant and equipment

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses. Depreciation is calculated on a straight-line basis to write-off the assets over their useful lives, which are generally between 5 and 20 years.

Property, plant and equipment is subject to review for impairment if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

p *Finance and operating leases*

(i) Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. Where the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to customers' as appropriate. Finance income receivable is recognised over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

(ii) Where the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. The finance lease and corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised over the periods of the leases based on the interest rates implicit in the leases so as to give a constant rate of interest on the remaining balance of the liability.

(iii) All other leases are classified as operating leases. Where the group is the lessor, the assets subject to the operating leases are included in 'Property, plant and equipment' and accounted for accordingly. Impairment losses are recognised to the extent that the carrying value of equipment is impaired through residual values not being fully recoverable. Where the group is the lessee, the leased assets are not recognised on the balance sheet.

(iv) Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the period of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

(v) Leasehold land is included under 'Other assets' in the balance sheet if such land is considered to be held under operating leases and is stated at cost less amortisation and impairment losses. Amortisation is calculated to write off the cost of the land on a straight-line basis over the terms of the leases.

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q *Income tax*

(i) Income tax for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in the statement of comprehensive income, in which case it is recognised in the statement of comprehensive income.

(ii) Current tax is the expected tax payable on the taxable income for the year, calculated using tax rates enacted or substantively enacted at the period end date, and any adjustment to tax payable in respect of previous years. The group provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

(iii) Deferred tax is recognised on temporary differences between the carrying amount of assets and liabilities in the balance sheet and the amount attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent it is probable that future taxable profits will be available against which deductible temporary differences can be used.

Deferred tax is calculated using the tax rates that have been enacted or substantively enacted at the period end date and are expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group, relate to income taxes levied by the same taxation authority, and a legal right to offset exists in the entity.

Deferred tax relating to actuarial gains and losses arising from post-employment benefit plans which are recognised in the statement of comprehensive income is also credited or charged to the statement of comprehensive income. Deferred tax relating to share-based payment transactions is recognised directly in equity to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense.

Deferred tax relating to changes in the fair value of available-for-sale investments and cash flow hedges, which are charged or credited directly to the statement of comprehensive income, is also credited or charged directly to the statement of comprehensive income and is recognised in the income statement when the fair value gain or loss is recognised in the income statement.

3 Summary of significant accounting policies *(continued)*

r *Pension and other post-retirement benefits*

The group operates a number of pension plans which include both defined benefit and defined contribution plans.

Payments to defined contribution plans and state-managed retirement benefit plans, where the group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The costs recognised for funding defined benefit plans are determined using the projected unit credit method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised in shareholders' equity and presented in the statement of 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.

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s *Share-based payments*

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

Fair value is determined by using 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 remaining vesting period.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

t *Foreign currencies*

Items included in each of the group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The group's financial statements are presented in Hong Kong dollars which is the Bank's functional currency.

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined.

The results of branches, subsidiaries and associates not reporting in Hong Kong dollars are translated into Hong Kong dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period-end are accounted for in a separate foreign exchange reserve in the consolidated financial statements.

Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate subsidiary's financial statements. In the consolidated financial statements, these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. On disposal of a foreign operation, exchange differences relating thereto previously recognised in reserves are recognised in the income statement.

u *Provisions*

Provisions for liabilities and charges are recognised when it is probable that an outflow of economic benefits will be required to settle a present legal or constructive obligation arising from past events and a reliable estimate can be made of the amount of the obligation.

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 non-occurrence, 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.

v *Financial guarantee contracts*

Liabilities under financial guarantee contracts which are not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

w *Insurance contracts*

Through its insurance subsidiaries, the group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the group accepts significant insurance risk from another party, by agreeing to compensate that party on the occurrence of a specified uncertain future event, is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

Insurance contracts are accounted for as follows:

3 Summary of significant accounting policies *(continued)*

Premiums

Premiums for life insurance contracts are accounted for when receivable, except in unit-linked insurance contracts where premiums are accounted for when liabilities are established.

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contracts based on the proportion of risks borne during the accounting period. The unearned premium (the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date) is calculated on a daily or monthly pro rata basis.

Reinsurance premiums are accounted for in the same accounting period as the premiums for the direct insurance contracts to which they relate.

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long-term investment contracts with discretionary participating features ('DPF') and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the equity holders' interest in the profits expected to emerge from those contracts written at the balance sheet date.

The present value of in-force long-term insurance business and long-term investment contracts with DPF, referred to as 'PVIF', is determined by discounting the equity holders' interest in future profits expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in 'Other operating income' on a gross of tax basis.

Claims and reinsurance recoveries

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising during the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

Gross insurance claims for non-life insurance contracts include paid claims and movements in outstanding claims liabilities.

Reinsurance recoveries are accounted for in the same period as the related claim.

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 under insurance contracts issued'.

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.

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

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 contractual 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.

3 Summary of significant accounting policies *(continued)*

x *Investment contracts*

Customer liabilities under linked and certain non-linked investment contracts without discretionary participation features and the corresponding financial assets are designated at fair value. Movements in fair value are recognised 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.

Liabilities under linked investment 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.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services, in 'Net fee income'.

y *Dividends*

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

z *Debt securities in issue and subordinated liabilities*

Debt securities issued for trading purposes or designated at fair value are reported under the appropriate balance sheet captions. Other debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest method and are reported under 'Debt securities in issue' or 'Subordinated liabilities'.

aa *Cash and cash equivalents*

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments comprise cash and balances with banks maturing within one month, and treasury bills and certificates of deposit with less than three months' maturity from the date of acquisition.

ab *Share capital*

Shares are classified as equity when the group has the unconditional right to avoid transferring cash or other financial assets to the holder.

ac *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 re-measurement 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.

4 Operating profit

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

a *Interest Income*

	2012 HK$m	2011 HK$m
Interest income on listed securities	**7,708**	8,004
Interest income on unlisted securities	**19,458**	17,989
Other interest income	**97,465**	89,699
	124,631	115,692
Less: interest income classified as 'Net trading income' (note 4(d))	**(9,064)**	(8,183)
Less: interest income classified as 'Net income from financial instruments designated at fair value'(note 4(e))	**(56)**	(51)
	115,511	107,458

Included in the above is interest income accrued on impaired financial assets of HK$174m (2011: HK$308m), including the unwinding of discounts on loan impairment losses of HK$152m (2011: HK$294m).

b *Interest expense*

	2012 HK$m	2011 HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**726**	831
Interest expense on preference shares	**2,386**	2,337
Other interest expense	**34,547**	32,867
	37,659	36,035
Less: interest expense classified as 'Net trading income' (note 4(d))	**(4,544)**	(4,225)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4(e))	**(23)**	(24)
	33,092	31,786

c *Net fee income*

	2012 HK$m	2011 HK$m
Net fee income includes the following:		
Net fee income, other than amounts included in determining the effective interest rate, arising from financial assets or financial liabilities that are not held for trading or designated at fair value		
– fee income	**15,315**	15,081
– fee expense	**(1,542)**	(1,415)
	13,773	13,666
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**8,287**	8,862
– fee expense	**(1,069)**	(1,213)
	7,218	7,649

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

d *Net trading income*

	2012 HK$m	2011 HK$m
Dealing profits	**16,633**	15,590
– Foreign exchange	**14,002**	15,313
– Interest rate derivatives	**2,145**	400
– Debt securities	**2,322**	1,300
– Equities and other trading	**(1,836)**	(1,423)
Loss from hedging activities	**(31)**	(71)
Fair value hedges		
– Net gain on hedged items attributable to the hedged risk	**345**	1,050
– Net loss on hedging instruments	**(376)**	(1,147)
– Other	**–**	26
Interest on trading assets and liabilities	**4,520**	3,958
– Interest income (note 4(a))	**9,064**	8,183
– Interest expense (note 4(b))	**(4,544)**	(4,225)
Dividend income from trading securities	**786**	722
– Listed investments	**653**	608
– Unlisted investments	**133**	114
Ping An contingent forward sale contract (note 28)	**(2,694)**	–
	19,214	20,199

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

	2012 HK$m	2011 HK$m
Income/(expense) on assets designated at fair value which back insurance and investment contracts	**6,670**	(4,542)
Change in fair value of liabilities to customers under investment contracts	**(2,209)**	30
	4,461	(4,512)
Net change in fair value of other financial assets/liabilities designated at fair value[1]	**119**	(38)
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	**56**	51
– Interest expense (note 4(b))	**(23)**	(24)
	4,613	(4,523)

1 *Gains and losses from changes in the fair value of the group's issued debt securities include those arising from changes in the group's own credit risk. In 2012 the group recognised a HK$22m loss on changes in the fair value of these instruments arising from changes in own credit risk (2011:HK$15m gain).*

f *Gains less losses from financial investments*

	2012 HK$m	2011 HK$m
Gains on disposal of available-for-sale securities	**2,809**	470
Impairment of available-for-sale equity investments	**(175)**	(342)
	2,634	128

There are no gains or losses on the disposal of held-to-maturity investments in the year (2011: nil).

4 Operating profit *(continued)*

g *Dividend income*

	2012 **HK$m**	2011 HK$m
Listed investments	**325**	431
Unlisted investments	**197**	298
	522	729

h *Other operating income*

	2012 **HK$m**	2011 HK$m
Rental income from investment properties	**216**	191
Movement in present value of in-force insurance business	**4,432**	5,524
Gains on investment properties	**834**	1,033
Gain/(loss) on disposal of property, plant and equipment, and assets held for sale	**30**	(3)
Gain/(loss) on disposal of subsidiaries, associates and business portfolios	**5,246**	(9)
Surplus arising on property revaluation	**2**	8
Other	**4,577**	4,645
	15,337	11,389

Other largely comprises recoveries of IT and other operating costs from shared services activities incurred on behalf of fellow Group companies. Other also includes recoveries against initial fair value on acquired loan portfolios of HK$650m (2011: HK$558m). There are no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2011: nil).

i *Loan impairment charges and other credit risk provisions*

	2012 **HK$m**	2011 HK$m
Net charge for impairment of loans and advances to customers		
– Individually assessed impairment allowances:		
New allowances	**2,201**	2,254
Releases	**(1,230)**	(1,204)
Recoveries	**(237)**	(356)
	734	694
– Net charge for collectively assessed impairment allowances	**2,596**	2,401
Net charge/(release) for other credit risk provisions	**248**	(36)
Net charge for loan impairment and other credit risk provisions	**3,578**	3,059

Included in the net charge for other credit risk provisions is an impairment release of HK$82m against available-for-sale debt securities (2011: impairment release of HK$4m). There are no impairment losses or provisions relating to held-to-maturity investments (2011: nil).

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

j *General and administrative expenses*

	2012 HK$m	2011 HK$m
Premises and equipment		
– Rental expenses	**3,292**	3,102
– Amortisation of prepaid operating lease payments	**18**	18
– Other premises and equipment expenses	**3,941**	3,810
	7,251	6,930
Marketing and advertising expenses	**3,578**	3,969
Other administrative expenses	**15,182**	13,453
	26,011	24,352

Included in operating expenses are direct operating expenses of HK$23m (2011: HK$19m) arising from investment properties that generated rental income during the year. Direct operating expenses arising from investment properties that did not generate rental income amounted to HK$1m (2011: HK$2m).

Included in operating expenses are minimum lease payments under operating leases of HK$3,361m (2011: HK$3,170m).

k *Auditors' remuneration*

Auditors' remuneration amounted to HK$77m (2011: HK$77m), of which HK$29m (2011: HK$29m) related to the Bank.

5 Insurance income

Included in the consolidated income statement are the following revenues earned by the insurance business:

a *Insurance income*

	2012 HK$m	2011 HK$m
Net interest income	**7,864**	6,779
Net fee income	**1,216**	692
Net trading income/(loss)	**56**	(386)
Net income/(expense) from financial instruments designated at fair value	**4,538**	(4,460)
Net earned insurance premiums (note 5(b))	**52,621**	45,670
Movement in present value of in-force business	**4,432**	5,524
Other operating income	**1,308**	237
	72,035	54,056
Net insurance claims incurred and movement in liabilities to policyholders (note 5(c))	**(54,983)**	(40,389)
Net operating income	**17,052**	13,667

5 Insurance income

b *Net earned insurance premiums*

	Non-life insurance HK$m	Life insurance (non-linked) HK$m	Life insurance (linked) HK$m	Investment contracts with discretionary participation features HK$m	Total HK$m
2012					
Gross written premiums	**2,935**	**41,405**	**10,605**	**–**	**54,945**
Movement in unearned premiums	**(385)**	**–**	**–**	**–**	**(385)**
Gross earned premiums	**2,550**	**41,405**	**10,605**	**–**	**54,560**
Gross written premiums ceded to reinsurers	**(365)**	**(1,587)**	**(11)**	**–**	**(1,963)**
Reinsurers' share of movement in unearned premiums	**24**	**–**	**–**	**–**	**24**
Reinsurers' share of gross earned premiums	**(341)**	**(1,587)**	**(11)**	**–**	**(1,939)**
Net earned premiums	**2,209**	**39,818**	**10,594**	**–**	**52,621**
2011					
Gross written premiums	3,318	36,000	7,312	–	46,630
Movement in unearned premiums	(183)	–	–	–	(183)
Gross earned premiums	3,135	36,000	7,312	–	46,447
Gross written premiums ceded to reinsurers	(455)	(311)	(10)	–	(776)
Reinsurers' share of movement in unearned premiums	(1)	–	–	–	(1)
Reinsurers' share of gross earned premiums	(456)	(311)	(10)	–	(777)
Net earned premiums	2,679	35,689	7,302	–	45,670

Notes on the Financial Statements (continued)

5 Insurance income *(continued)*

c *Net insurance claims incurred and movement in liabilities to policyholders*

	Non-life insurance HK$m	Life insurance (non-linked) HK$m	Life insurance (linked) HK$m	Investment contracts with discretionary participation features HK$m	Total HK$m
2012					
Claims, benefits and surrenders paid	**1,135**	**6,931**	**7,286**	**62**	**15,414**
Movement in provision	**71**	**35,445**	**3,686**	**(61)**	**39,141**
Gross claims incurred and movement in liabilities to policyholders	**1,206**	**42,376**	**10,972**	**1**	**54,555**
Reinsurers' share of claims, benefits and surrenders paid	**(98)**	**(143)**	**(5,233)**	**–**	**(5,474)**
Reinsurers' share of movement in provision	**(1)**	**(1,172)**	**7,075**	**–**	**5,902**
Reinsurers' share of claims incurred and movement in liabilities to policyholders	**(99)**	**(1,315)**	**1,842**	**–**	**428**
Net insurance claims incurred and movement in liabilities to policyholders	**1,107**	**41,061**	**12,814**	**1**	**54,983**
2011					
Claims, benefits and surrenders paid	1,420	6,399	1,958	85	9,862
Movement in provision	(33)	30,598	1,192	(84)	31,673
Gross claims incurred and movement in liabilities to policyholders	1,387	36,997	3,150	1	41,535
Reinsurers' share of claims, benefits and surrenders paid	(147)	(178)	(385)	–	(710)
Reinsurers' share of movement in provision	(14)	(5)	(417)	–	(436)
Reinsurers' share of claims incurred and movement in liabilities to policyholders	(161)	(183)	(802)	–	(1,146)
Net insurance claims incurred and movement in liabilities to policyholders	1,226	36,814	2,348	1	40,389

6 Employee compensation and benefits

a *Employee compensation and benefits*

	2012 HK$m	2011 HK$m
Wages and salaries	**34,233**	35,020
Social security costs	**935**	912
Retirement benefit costs		
– Defined contribution plans	**1,063**	1,043
– Defined benefit plans (note 6(c)(v))	**790**	859
	37,021	37,834

b *Directors' emoluments*

The aggregate emoluments of the Directors of the Bank, calculated in accordance with section 161 of the Hong Kong Companies Ordinance, were HK$74m (2011: HK$71m). This comprises fees of HK$8m (2011: HK$6m) and other emoluments of HK$66m (2011: HK$66m) which includes pension benefits of HK$1m (2011: HK$1m).

c *Retirement benefit pension plans*

The group operates 85 (2011: 80) retirement benefit plans, with a total cost of HK$1,853m (2011: HK$1,902m), of which HK$658m (2011: HK$587m) relates to overseas plans and HK$19m (2011: HK$30m) to a plan sponsored by HSBC Asia Holdings BV.

Progressively the HSBC Group has been moving to defined contribution plans for all new employees.

The group's defined benefit plans, which cover 26% (2011: 35%) of employees, are predominantly funded plans with assets which, in the case of the larger plans, are held either under insurance policies or in trust funds separate from the group. The cost relating to the funded plans was HK$722m (2011: HK$804m) which was assessed in accordance with the advice of qualified actuaries; the plans are reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the projected benefit obligations of the group's retirement benefit plans vary according to the economic conditions of the countries in which they are situated.

(i) Defined benefit plan principal actuarial assumptions

The principal actuarial assumptions used to calculate the assets and liabilities of the major defined benefit pension plans were:

	2012 % p.a.	2011 % p.a.
Discount rate	**0.60**	1.47
Expected rates of return on plan assets[1]		
– equities	**8.4**	7.5
– bonds	**2.8**	3.9
– other	**4.5**	3.9
Rate of pay increase		
– long term	**4.0**	5.0
Mortality table	**HKLT2011[2]**	HKLT2001[3]

1 *The expected rates of return in 2011 were used to measure the expected return on plan assets in the subsequent year, i.e. 2012. The rates under 2012, however, are for reference only as starting from 2013, the interest cost and the expected return on plan assets will be replaced by the net interest component on the net defined benefit liability or asset under HKAS 19 (revised) 'Employee Benefits'. Details are included under note 1c 'Future Accounting Developments'. The expected rates of return as shown above are weighted on the basis of the fair value of the plan assets.*

2 *HKLT2011 – Hong Kong Life Tables 2011.*

3 *HKLT2001 – Hong Kong Life Tables 2001.*

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

The overall expected long-term rate of return on assets as at 31 December 2012 was 4.6% (2011: 4.7%). The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The return is based on historical market returns adjusted for additional factors such as the current rate of inflation and interest rates.

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of the Bank and certain other local employees of HSBC Group. The scheme comprises a funded defined benefit scheme (which provides a lump sum on retirement but is now closed to new members) and a defined contribution scheme. The latter was established on 1 January 1999 for new employees. The latest valuation of the defined benefit scheme was made at 31 December 2010 and was performed by Wing Lui, Fellow of the Society of Actuaries of the United States of America, of Towers Watson Hong Kong Limited, an external consultant. At that valuation date, the market value of the defined benefit scheme's assets was HK$8,611m. On an ongoing basis, the actuarial value of the scheme's assets represented 104% of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries, and the resulting surplus amounted to HK$319m. On a wind-up basis, the scheme's assets represents 110% of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK$808m. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 6% per annum and long-term salary increases of 5% per annum.

(ii) Value recognised in the balance sheet

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Equities	**3,977**	3,162	**2,176**	1,483
Bonds	**9,050**	9,357	**6,106**	6,600
Other	**1,549**	1,594	**1,047**	1,269
Fair value of plan assets	**14,576**	14,113	**9,329**	9,352
Present value of funded obligations	**20,835**	21,699	**12,772**	13,186
Present value of unfunded obligations	**402**	402	**243**	247
Defined benefit obligations	**21,237**	22,101	**13,015**	13,433
Past service (credit)/ cost not recognised	**(2)**	3	**–**	5
Effect of limit on plan surpluses	**1**	1	**1**	1
Net defined benefit liability	**(6,664)**	(7,986)	**(3,687)**	(4,077)
Reported as 'Assets'	**61**	111	**23**	73
Reported as 'Liabilities'	**(6,725)**	(8,097)	**(3,710)**	(4,150)
Net defined benefit liability	**(6,664)**	(7,986)	**(3,687)**	(4,077)

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

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**22,101**	19,308	**13,433**	12,156
Current service cost	**1,126**	1,024	**706**	658
Interest cost	**398**	591	**265**	390
Contributions by employees	**2**	2	**–**	–
Actuarial (gains)/losses	**(385)**	2,641	**(92)**	1,263
Benefits paid	**(1,694)**	(1,203)	**(1,167)**	(848)
Past service cost – vested immediately	**1**	28	**–**	27
Liabilities extinguished on settlements	**(186)**	(195)	**–**	(128)
Exchange and other movements	**(126)**	(95)	**(130)**	(85)
At 31 December	**21,237**	22,101	**13,015**	13,433

6 Employee compensation and benefits *(continued)*

(iv) Changes in the fair value of plan assets

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**14,113**	14,887	**9,352**	9,859
Expected return	**674**	754	**460**	510
Contributions by the group/the Bank	**876**	718	**394**	436
Contributions by employees	**2**	2	**–**	–
Actuarial gains/(losses)	**694**	(880)	**323**	(471)
Benefits paid	**(1,541)**	(1,140)	**(1,065)**	(808)
Assets distributed on settlement	**(113)**	(153)	**–**	(101)
Exchange and other movements	**(129)**	(75)	**(135)**	(73)
At 31 December	**14,576**	14,113	**9,329**	9,352

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

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Equities	**155**	341	**80**	284
Others	**65**	179	**14**	132
	220	520	**94**	416

The group's actual gain on plan assets for the year ended 31 December 2012 was HK$1,369m (2011: HK$157m loss). The Bank's actual gain on plan assets for the year ended 31 December 2012 was HK$783m (2011: HK$8m).

The group expects to make HK$669m of contributions to defined benefit pension plans during 2013. Contributions to be made by the Bank are expected to be HK$378m.

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

	2012	2011
	HK$m	HK$m
Current service cost	**1,126**	1,024
Interest cost	**398**	591
Expected return on plan assets	**(674)**	(754)
Past service costs	**5**	37
Gains on settlements/curtailments	**(65)**	(39)
Total net expense	**790**	859

The total net actuarial gains recognised in total equity during 2012 in respect of defined benefit pension plans was HK$1,079m (2011: HK$3,518m loss). After deduction of non-controlling interests, a gain of HK$850m (2011: HK$2,912m loss) was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date are HK$9,219m (2011: HK$10,298m). After deduction of non-controlling interests, the total net actuarial losses recognised in total shareholders' equity to date are HK$7,979m (2011: HK$8,829m).

The total net actuarial gain recognised in the Bank's retained profits during 2012 in respect of defined benefit pension plans was HK$415m (2011: HK$1,727m loss). Total net actuarial losses recognised outside of the income statement to date are HK$5,573m (2011: HK$5,988m).

The total effect of the limit on plan surpluses recognised within actuarial losses in equity for both the group and the Bank during 2012 was nil (2011: nil).

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

(vi) Amounts for the current and previous years

	The group					The Bank				
	2012	2011	2010	2009	2008	**2012**	2011	2010	2009	2008
	HK$m	HK$m	HK$m	HK$m	HK$m	**HK$m**	HK$m	HK$m	HK$m	HK$m
Defined benefit obligations	**21,237**	22,101	19,308	17,948	20,954	**13,015**	13,433	12,156	11,437	12,841
Plan assets	**14,576**	14,113	14,887	14,318	13,588	**9,329**	9,353	9,859	9,627	9,379
Net deficit	**(6,661)**	(7,988)	(4,421)	(3,630)	(7,366)	**(3,686)**	(4,080)	(2,297)	(1,810)	(3,462)
Experience gains/(losses) on plan liabilities	**374**	(344)	(214)	408	(132)	**154**	(230)	(175)	60	(363)
Experience gains/(losses) on plan assets	**694**	(911)	2	368	(3,591)	**323**	(502)	(59)	(47)	(1,400)

7 Tax expense

a The Bank and its subsidiaries in Hong Kong have provided for Hong Kong profits tax at the rate of 16.5% (2011: 16.5%) on the profits for the year assessable in Hong Kong. Overseas branches and subsidiaries have similarly provided for tax in the countries in which they operate at the appropriate rates of tax ruling in 2012. Deferred taxation is provided for in accordance with the group's accounting policy in note 3(q).

The charge for taxation in the income statement comprises:

	2012	2011
	HK$m	HK$m
Current income tax		
– Hong Kong profits tax – on current year profit	**7,810**	6,395
– Hong Kong profits tax – adjustments in respect of prior years	**(20)**	145
– Overseas taxation – on current year profit	**10,631**	9,593
– Overseas taxation – adjustments in respect of prior years	**(203)**	(219)
	18,218	15,914
Deferred tax		
– Origination and reversal of temporary differences	**35**	1,494
– Effect of changes in tax rates	**65**	8
– Adjustments in respect of prior years	**(308)**	50
	(208)	1,552
	18,010	17,466

7 Tax expense *(continued)*

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

(i) Deferred tax assets

The group

	Accelerated capital allowances and short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2012						
At 1 January	**1,154**	**–**	**782**	**(740)**	**1,129**	**2,325**
Exchange and other adjustments	**415**	**–**	**(404)**	**(65)**	**(225)**	**(279)**
Credit to income statement	**98**	**–**	**516**	**4**	**197**	**815**
Credit/(charge) to reserves	**–**	**–**	**–**	**1**	**(233)**	**(232)**
At 31 December	**1,667**	**–**	**894**	**(800)**	**868**	**2,629**
2011						
At 1 January	1,669	–	896	(852)	802	2,515
Exchange and other adjustments	(611)	–	98	102	170	(241)
Credit/(charge) to income statement	96	–	(212)	(1)	134	17
Credit to reserves	–	–	–	11	23	34
At 31 December	1,154	–	782	(740)	1,129	2,325

The Bank

	Accelerated capital allowances and short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2012						
At 1 January	**522**	**–**	**544**	**(723)**	**755**	**1,098**
Exchange and other adjustments	**120**	**–**	**(83)**	**(21)**	**(95)**	**(79)**
Credit to income statement	**72**	**–**	**125**	**2**	**273**	**472**
Credit/(charge) to reserves	**–**	**–**	**–**	**12**	**(170)**	**(158)**
At 31 December	**714**	**–**	**586**	**(730)**	**763**	**1,333**
2011						
At 1 January	616	–	846	(797)	439	1,104
Exchange and other adjustments	(289)	–	(67)	59	109	(188)
Credit/(charge) to income statement	195	–	(235)	(2)	169	127
Credit to reserves	–	–	–	17	38	55
At 31 December	522	–	544	(723)	755	1,098

Notes on the Financial Statements (continued)

7 Tax expense *(continued)*

(ii) Deferred tax liabilities

The group

	Accelerated capital allowances and short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2012						
At 1 January	**5,734**	**(30)**	**5**	**9,608**	**(605)**	**14,712**
Exchange and other adjustments	**(654)**	**–**	**(293)**	**(99)**	**797**	**(249)**
Charge/(credit) to income statement	**1,700**	**–**	**26**	**(867)**	**(252)**	**607**
Charge to reserves	**–**	**–**	**–**	**1,162**	**691**	**1,853**
At 31 December	**6,780**	**(30)**	**(262)**	**9,804**	**631**	**16,923**
2011						
At 1 January	4,680	(31)	(295)	7,456	103	11,913
Exchange and other adjustments	(278)	(1)	(56)	57	74	(204)
Charge/(credit) to income statement	1,332	2	356	16	(137)	1,569
Charge/(credit) to reserves	–	–	–	2,079	(645)	1,434
At 31 December	5,734	(30)	5	9,608	(605)	14,712

The Bank

	Accelerated capital allowances and short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2012						
At 1 January	**962**	**(30)**	**(236)**	**5,359**	**(171)**	**5,884**
Exchange and other adjustments	**(625)**	**–**	**(12)**	**(57)**	**631**	**(63)**
Charge/(credit) to income statement	**(36)**	**–**	**18**	**(98)**	**(353)**	**(469)**
Charge to reserves	**–**	**–**	**–**	**601**	**241**	**842**
At 31 December	**301**	**(30)**	**(230)**	**5,805**	**348**	**6,194**
2011						
At 1 January	1,124	(31)	(211)	4,230	413	5,525
Exchange and other adjustments	(140)	–	(5)	15	14	(116)
(Credit)/charge to income statement	(22)	1	(20)	(76)	(184)	(301)
Charge/(credit) to reserves	–	–	–	1,190	(414)	776
At 31 December	962	(30)	(236)	5,359	(171)	5,884

7 Tax expense *(continued)*

(iii) Net deferred tax liabilities

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Deferred tax liabilities recognised on the balance sheet	**16,923**	14,712	**6,194**	5,884
Deferred tax assets recognised on the balance sheet	**(2,629)**	(2,325)	**(1,333)**	(1,098)
	14,294	12,387	**4,861**	4,786

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK$3,891m (2011: HK$3,777m). Of this amount, HK$2,041m (2011: HK$2,062m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK$2,084m (2011: HK$1,164m) has been provided in respect of distributable reserves or post-acquisition reserves of associates that, on distribution or sale, would attract withholding tax.

Deferred tax is not recognised in respect of the group's investments in subsidiaries and branches where remittance or other realisation is not probable, and for those associates and interests in joint ventures where it has been determined that no additional tax will arise.

c *Provisions for taxation*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong profits tax	**1,168**	658	**215**	251
Overseas taxation	**2,674**	3,468	**2,133**	2,497
Current tax liabilities	**3,842**	4,126	**2,348**	2,748
Deferred tax liabilities	**16,923**	14,712	**6,194**	5,884
	20,765	18,838	**8,542**	8,632

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

	2012	2011
	HK$m	HK$m
Profit before tax	**108,729**	91,370
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**21,376**	18,633
Adjustments in respect of prior years	**(531)**	(24)
Deferred tax temporary differences (previously not recognised) / not recognised	**(17)**	58
Effects of profits in associates and joint ventures	**(3,104)**	(2,489)
Non taxable income and gains	**(2,381)**	(1,654)
Permanent disallowables	**1,609**	928
Change in tax rates	**65**	8
Local taxes and overseas withholding taxes	**970**	632
Others	**23**	1,374
	18,010	17,466

Notes on the Financial Statements (continued)

8 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$48,377m (2011: HK$37,812m) which has been dealt with in the accounts of the Bank.

9 Dividends

	2012		2011	
	HK$ per share	**HK$m**	HK$ per share	HK$m
Ordinary dividends paid				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	**0.83**	**10,000**	1.33	12,000
– first interim dividend paid	**0.58**	**7,500**	0.78	7,000
– second interim dividend paid	**0.41**	**7,500**	0.78	7,000
– third interim dividend paid	**0.40**	**7,500**	0.68	7,000
	2.22	**32,500**	3.57	33,000

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2012 of HK$20,000m (HK$0.85 per ordinary share).

10 Analysis of financial assets and liabilities by measurement basis

The group

	At 31 December 2012								
	Held for trading HK$m	Designated at fair value HK$m	Held-to-maturity securities HK$m	Loans and receivables HK$m	Available-for-sale securities HK$m	Financial assets and liabilities at amortised cost HK$m	Derivatives designated as fair value hedging instruments HK$m	Derivatives designated as cash flow hedging instruments HK$m	Total HK$m
Assets									
Cash and short-term funds	–	–	–	362,197	534,898	214,104	–	–	1,111,199
Items in the course of collection from other banks	–	–	–	–	–	23,079	–	–	23,079
Placings with banks maturing after one month	–	–	–	184,711	–	–	–	–	184,711
Certificates of deposit	–	–	8,426	–	84,659	–	–	–	93,085
Hong Kong Government certificates of indebtedness	–	–	–	–	–	176,264	–	–	176,264
Trading assets	419,697	–	–	–	–	–	–	–	419,697
Financial assets designated at fair value	–	69,479	–	–	–	–	–	–	69,479
Derivatives	394,787	–	–	–	–	–	359	3,810	398,956
Loans and advances to customers	–	–	–	2,349,043	–	–	–	–	2,349,043
Financial investments	–	–	155,393	–	470,649	–	–	–	626,042
Amounts due from Group companies	6,710	4,966	–	–	–	164,328	–	–	176,004
Other assets	–	200	–	–	45,918	79,432	–	–	125,550
Total financial assets	821,194	74,645	163,819	2,895,951	1,136,124	657,207	359	3,810	5,753,109
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	176,264	–	–	176,264
Items in the course of transmission to other banks	–	–	–	–	–	35,525	–	–	35,525
Deposits by banks	–	–	–	–	–	244,135	–	–	244,135
Customer accounts	–	–	–	–	–	3,874,884	–	–	3,874,884
Trading liabilities	183,340	–	–	–	–	–	–	–	183,340
Financial liabilities designated at fair value	–	44,270	–	–	–	–	–	–	44,270
Derivatives	393,264	–	–	–	–	–	3,626	261	397,151
Debt securities in issue	–	–	–	–	–	74,647	–	–	74,647
Amounts due to Group companies	27,112	2	–	–	–	70,504	–	–	97,618
Other liabilities	–	175	–	–	–	84,549	–	–	84,724
Subordinated liabilities	–	–	–	–	–	13,867	–	–	13,867
Preference shares	–	–	–	–	–	83,346	–	–	83,346
Total financial liabilities	603,716	44,447	–	–	–	4,657,721	3,626	261	5,309,771

Notes on the Financial Statements (continued)

10 Analysis of financial assets and liabilities by measurement basis *(continued)*

The group

	At 31 December 2011								
	Held for trading HK$m	Designated at fair value HK$m	Held-to-maturity securities HK$m	Loans and receivables HK$m	Available-for-sale securities HK$m	Financial assets and liabilities at amortised cost HK$m	Derivatives designated as fair value hedging instruments HK$m	Derivatives designated as cash flow hedging instruments HK$m	Total HK$m
Assets									
Cash and short-term funds	–	–	–	456,294	353,505	110,107	–	–	919,906
Items in the course of collection from other banks	–	–	–	–	–	34,546	–	–	34,546
Placings with banks maturing after one month	–	–	–	198,287	–	–	–	–	198,287
Certificates of deposit	–	–	8,342	–	80,349	–	–	–	88,691
Hong Kong Government certificates of indebtedness	–	–	–	–	–	162,524	–	–	162,524
Trading assets	447,968	–	–	–	–	–	–	–	447,968
Financial assets designated at fair value	–	57,670	–	–	–	–	–	–	57,670
Derivatives	376,636	–	–	–	–	–	389	271	377,296
Loans and advances to customers	–	–	–	2,130,871	–	–	–	–	2,130,871
Financial investments	–	–	134,720	–	587,713	–	–	–	722,433
Amounts due from Group companies	11,121	5,390	–	–	–	136,219	–	–	152,730
Other assets	–	–	–	–	–	77,521	–	–	77,521
Total financial assets	835,725	63,060	143,062	2,785,452	1,021,567	520,917	389	271	5,370,443
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	162,524	–	–	162,524
Items in the course of transmission to other banks	–	–	–	–	–	47,163	–	–	47,163
Deposits by banks	–	–	–	–	–	222,582	–	–	222,582
Customer accounts	–	–	–	–	–	3,565,001	–	–	3,565,001
Trading liabilities	171,431	–	–	–	–	–	–	–	171,431
Financial liabilities designated at fair value	–	40,392	–	–	–	–	–	–	40,392
Derivatives	379,989	–	–	–	–	–	3,045	218	383,252
Debt securities in issue	–	–	–	–	–	77,472	–	–	77,472
Amounts due to Group companies	37,675	5	–	–	–	70,743	–	–	108,423
Other liabilities	–	–	–	–	–	102,321	–	–	102,321
Subordinated liabilities	–	–	–	–	–	16,114	–	–	16,114
Preference shares	–	–	–	–	–	97,096	–	–	97,096
Total financial liabilities	589,095	40,397	–	–	–	4,361,016	3,045	218	4,993,771

10 Analysis of financial assets and liabilities by measurement basis *(continued)*

The Bank

	At 31 December 2012								
	Held for trading HK$m	Designated at fair value HK$m	Held-to-maturity securities HK$m	Loans and receivables HK$m	Available-for-sale securities HK$m	Financial assets and liabilities at amortised cost HK$m	Derivatives designated as fair value hedging instruments HK$m	Derivatives designated as cash flow hedging instruments HK$m	Total HK$m
Assets									
Cash and short-term funds	–	–	–	165,904	419,345	175,938	–	–	761,187
Items in the course of collection from other banks	–	–	–	–	–	17,355	–	–	17,355
Placings with banks maturing after one month	–	–	–	80,200	–	–	–	–	80,200
Certificates of deposit	–	–	–	–	20,150	–	–	–	20,150
Hong Kong Government certificates of indebtedness	–	–	–	–	–	176,264	–	–	176,264
Trading assets	284,573	–	–	–	–	–	–	–	284,573
Financial assets designated at fair value	–	1,432	–	–	–	–	–	–	1,432
Derivatives	388,298	–	–	–	–	–	65	3,476	391,839
Loans and advances to customers	–	–	–	1,282,720	–	–	–	–	1,282,720
Financial investments	–	–	–	–	260,317	–	–	–	260,317
Amounts due from Group companies	13,126	–	–	–	–	308,474	–	–	321,600
Other assets	–	–	–	–	43,691	45,232	–	–	88,923
Total financial assets	685,997	1,432	–	1,528,824	743,503	723,263	65	3,476	3,686,560
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	176,264	–	–	176,264
Items in the course of transmission to other banks	–	–	–	–	–	25,766	–	–	25,766
Deposits by banks	–	–	–	–	–	204,520	–	–	204,520
Customer accounts	–	–	–	–	–	2,417,400	–	–	2,417,400
Trading liabilities	82,146	–	–	–	–	–	–	–	82,146
Financial liabilities designated at fair value	–	7,731	–	–	–	–	–	–	7,731
Derivatives	390,282	–	–	–	–	–	1,632	170	392,084
Debt securities in issue	–	–	–	–	–	40,406	–	–	40,406
Amounts due to Group companies	18,969	–	–	–	–	130,268	–	–	149,237
Other liabilities	–	–	–	–	–	53,011	–	–	53,011
Subordinated liabilities	–	–	–	–	–	9,355	–	–	9,355
Preference shares	–	–	–	–	–	83,195	–	–	83,195
Total financial liabilities	491,397	7,731	–	–	–	3,140,185	1,632	170	3,641,115

10 Analysis of financial assets and liabilities by measurement basis *(continued)*

The Bank

	At 31 December 2011								
	Held for trading HK$m	Designated at fair value HK$m	Held-to-maturity securities HK$m	Loans and receivables HK$m	Available-for-sale securities HK$m	Financial assets and liabilities at amortised cost HK$m	Derivatives designated as fair value hedging instruments HK$m	Derivatives designated as cash flow hedging instruments HK$m	Total HK$m
Assets									
Cash and short-term funds	–	–	–	232,654	299,701	79,910	–	–	612,265
Items in the course of collection from other banks	–	–	–	–	–	29,821	–	–	29,821
Placings with banks maturing after one month	–	–	–	108,873	–	–	–	–	108,873
Certificates of deposit	–	–	–	–	23,987	–	–	–	23,987
Hong Kong Government certificates of indebtedness	–	–	–	–	–	162,524	–	–	162,524
Trading assets	317,321	–	–	–	–	–	–	–	317,321
Financial assets designated at fair value	–	2,283	–	–	–	–	–	–	2,283
Derivatives	370,361	–	–	–	–	–	150	167	370,678
Loans and advances to customers	–	–	–	1,176,602	–	–	–	–	1,176,602
Financial investments	–	–	–	–	362,307	–	–	–	362,307
Amounts due from Group companies	14,455	–	–	–	–	233,546	–	–	248,001
Other assets	–	–	–	–	–	43,059	–	–	43,059
Total financial assets	702,137	2,283	–	1,518,129	685,995	548,860	150	167	3,457,721
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	162,524	–	–	162,524
Items in the course of transmission to other banks	–	–	–	–	–	38,577	–	–	38,577
Deposits by banks	–	–	–	–	–	158,746	–	–	158,746
Customer accounts	–	–	–	–	–	2,220,072	–	–	2,220,072
Trading liabilities	78,959	–	–	–	–	–	–	–	78,959
Financial liabilities designated at fair value	–	5,910	–	–	–	–	–	–	5,910
Derivatives	375,712	–	–	–	–	–	1,343	110	377,165
Debt securities in issue	–	–	–	–	–	46,360	–	–	46,360
Amounts due to Group companies	33,258	–	–	–	–	119,648	–	–	152,906
Other liabilities	–	–	–	–	–	67,758	–	–	67,758
Subordinated liabilities	–	–	–	–	–	9,386	–	–	9,386
Preference shares	–	–	–	–	–	96,969	–	–	96,969
Total financial liabilities	487,929	5,910	–	–	–	2,920,040	1,343	110	3,415,332

11 Cash and short-term funds

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Cash in hand	**17,925**	15,204	**11,139**	7,888
Sight balances with central banks	**196,179**	94,903	**164,799**	72,022
Placings with banks with remaining maturity of one month or less	**362,197**	456,294	**165,904**	232,654
Treasury bills and other eligible bills	**534,898**	353,505	**419,345**	299,701
	1,111,199	919,906	**761,187**	612,265

As at 31 December 2012, included within notes 11 and 12, the total amount placed with central banks by the group, including sight balances, amounted to HK$356,880m (2011: HK$350,823m). Placings with central banks made by the Bank amounted to HK$230,427m (2011: HK$211,307m).

Treasury bills and other eligible bills are analysed as follows:

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Treasury bills and other eligible bills – available-for-sale				
– subject to repledge or resale by counterparties	**512**	498	**512**	498
– not subject to repledge or resale by counterparties	**534,386**	353,007	**418,833**	299,203
	534,898	353,505	**419,345**	299,701

Treasury bills and other eligible bills held for trading are included under 'Trading assets' (note 15). Treasury bills and other eligible bills are largely unlisted.

12 Placings with banks maturing after one month

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Gross placings with banks maturing after one month but not more than one year	**150,504**	173,498	**58,846**	93,098
Gross placings with banks maturing after one year	**34,207**	24,789	**21,354**	15,775
Total placings with banks	**184,711**	198,287	**80,200**	108,873

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

13 Certificates of deposit

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Held-to-maturity	**8,426**	8,342	**–**	–
Available-for-sale	**84,659**	80,349	**20,150**	23,987
	93,085	88,691	**20,150**	23,987

Certificates of deposit held are largely unlisted. There were no disposals of held-to-maturity certificates of deposit during the year (2011: nil).

14 Hong Kong currency notes in circulation

Hong Kong currency notes in circulation are secured by the deposit of funds in respect of which the Hong Kong Government certificates of indebtedness are held.

Notes on the Financial Statements (continued)

15 Trading assets

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**176,757**	168,849	**125,372**	120,575
Equity shares	**30,401**	15,060	**30,250**	14,978
Treasury bills and other eligible bills	**155,464**	230,959	**116,214**	160,911
Other	**57,075**	33,100	**12,737**	20,857
	419,697	447,968	**284,573**	317,321
Trading assets				
– which may be repledged or resold by counterparties	**651**	281	**651**	281
– not subject to repledge or resale by counterparties	**419,046**	447,687	**283,922**	317,040
	419,697	447,968	**284,573**	317,321

The amount of listed treasury bills and other eligible bills amounted to HK$2,838m at both group and Bank level as at 31 December 2012 (2011: HK$4,427m).

'Other' trading assets primarily includes reverse repos, settlement accounts and stock borrowing transactions with banks and customers.

a *Debt securities*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**11,377**	17,880	**8,330**	13,329
– listed outside Hong Kong	**62,102**	54,897	**61,791**	54,180
	73,479	72,777	**70,121**	67,509
Unlisted	**103,278**	96,072	**55,251**	53,066
	176,757	168,849	**125,372**	120,575
Issued by public bodies				
– central governments and central banks	**128,866**	114,322	**89,724**	77,477
– other public sector entities	**7,160**	6,651	**6,760**	6,544
	136,026	120,973	**96,484**	84,021
Issued by				
– banks	**16,870**	23,984	**12,922**	19,811
– corporate entities	**23,861**	23,892	**15,966**	16,743
	176,757	168,849	**125,372**	120,575

b *Equity shares*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**10,543**	4,494	**10,513**	4,487
– listed outside Hong Kong	**13,884**	7,211	**13,884**	7,211
	24,427	11,705	**24,397**	11,698
Unlisted	**5,974**	3,355	**5,853**	3,280
	30,401	15,060	**30,250**	14,978
Issued by				
– banks	**2,986**	2,192	**2,986**	2,192
– corporate entities	**27,415**	12,868	**27,264**	12,786
	30,401	15,060	**30,250**	14,978

16 Financial assets designated at fair value

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**17,001**	16,762	**1,432**	2,283
Equity shares	**52,058**	40,268	**–**	–
Other	**420**	640	**–**	–
	69,479	57,670	**1,432**	2,283

a *Debt securities*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**1,884**	1,780	**576**	587
– listed outside Hong Kong	**4,365**	4,578	**856**	1,696
	6,249	6,358	**1,432**	2,283
Unlisted	**10,752**	10,404	**–**	–
	17,001	16,762	**1,432**	2,283
Issued by public bodies				
– central governments and central banks	**2,135**	2,298	**576**	587
– other public sector entities	**1,586**	1,992	**–**	–
	3,721	4,290	**576**	587
Issued by other bodies				
– banks	**5,330**	5,153	**–**	–
– corporate entities	**7,950**	7,319	**856**	1,696
	17,001	16,762	**1,432**	2,283

b *Equity shares*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**5,790**	3,354	**–**	–
– listed outside Hong Kong	**19,682**	14,732	**–**	–
	25,472	18,086	**–**	–
Unlisted	**26,586**	22,182	**–**	–
	52,058	40,268	**–**	–
Issued by				
– banks	**2,365**	1,386	**–**	–
– corporate entities	**49,693**	38,882	**–**	–
	52,058	40,268	**–**	–

17 Derivatives

Derivatives are financial instruments that derive their value from the price of an underlying item such as equities, bonds, interest rates, foreign exchange rates, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposures to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposures to credit and market risks.

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. A description of how the fair value of derivatives is derived is set out in note 51.

Derivative assets and liabilities on different transactions are only offset if the transactions are with the same counterparty, a legal right of offset exists and the cash flows are intended to be settled on a net basis. Changes in the values of derivatives are recognised in accordance with the group's accounting policy as described in note 3(j).

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio risk arising from client business, and to manage and hedge the group's own risks. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in HKAS 39. All other derivative instruments are classified as held for trading.

The held for trading classification includes two types of derivative instruments. The first type are those used in sales and trading activities, including those instruments that are used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second type of held for trading category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with offsetting deals being used to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures as are used for traditional lending.

a *Trading derivatives*

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

17 Derivatives *(continued)*

Contract amounts and fair values of assets and liabilities by class of derivatives

The notional contract amounts of derivatives held indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

The group

	2012			2011		
	Contract Amounts HK$m	**Assets HK$m**	**Liabilities HK$m**	Contract amounts HK$m	Assets HK$m	Liabilities HK$m
Trading derivatives						
Exchange rate contracts	**12,166,808**	**182,941**	**185,274**	10,996,534	172,868	181,560
– spot and forward	**8,062,408**	**80,839**	**75,494**	7,347,246	81,683	74,197
– swaps	**3,219,733**	**98,168**	**106,514**	2,983,663	82,852	100,711
– options purchased	**394,957**	**3,205**	**119**	250,711	7,862	360
– options written	**429,401**	**372**	**2,861**	285,008	368	6,064
– other	**60,309**	**357**	**286**	129,906	103	228
Interest rate contracts	**18,115,892**	**200,790**	**193,208**	17,283,126	174,078	169,313
– forward and future	**639,265**	**311**	**92**	898,955	143	173
– swaps	**16,919,103**	**195,781**	**189,097**	15,544,934	168,767	164,062
– options purchased	**222,359**	**2,468**	**28**	378,709	3,707	80
– options written	**282,512**	**3**	**2,988**	423,074	–	3,865
– other	**52,653**	**2,227**	**1,003**	37,454	1,461	1,133
Equity derivatives	**818,543**	**29,824**	**33,607**	785,433	29,729	31,066
Credit derivatives	**335,214**	**2,631**	**2,655**	465,174	5,000	4,784
Commodity and other	**114,226**	**1,173**	**1,175**	87,764	2,713	1,054
Total held for trading	**31,550,683**	**417,359**	**415,919**	29,618,031	384,388	387,777
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**546**	**5**	**–**	546	3	–
Interest rate contracts	**6,573**	**123**	**45**	4,835	128	95
	7,119	**128**	**45**	5,381	131	95
Cash flow hedging derivatives						
Exchange rate contracts	**40,044**	**3,740**	**151**	2,679	–	79
Interest rate contracts	**40,216**	**70**	**110**	101,069	271	139
	80,260	**3,810**	**261**	103,748	271	218
Fair value hedging derivatives						
Interest rate contracts	**114,887**	**359**	**3,626**	109,477	389	3,045
Gross total derivatives	**31,752,949**	**421,656**	**419,851**	29,836,637	385,179	391,135
Netting	**–**	**(22,700)**	**(22,700)**	–	(7,883)	(7,883)
Total	**31,752,949**	**398,956**	**397,151**	29,836,637	377,296	383,252

Notes on the Financial Statements (continued)

17 Derivatives *(continued)*

The Bank

	2012			2011		
	Contract amounts HK$m	**Assets HK$m**	**Liabilities HK$m**	Contract Amounts HK$m	Assets HK$m	Liabilities HK$m
Trading derivatives						
Exchange rate contracts	**10,989,189**	**177,543**	**182,472**	10,080,072	168,229	178,375
– spot and forward	**7,181,287**	**76,898**	**73,425**	6,643,385	78,232	71,804
– swaps	**3,190,866**	**97,084**	**106,156**	2,964,442	82,177	100,445
– options purchased	**270,035**	**2,926**	**119**	152,018	7,352	376
– options written	**301,789**	**307**	**2,504**	189,536	369	5,529
– other	**45,212**	**328**	**268**	130,691	99	221
Interest rate contracts	**17,697,104**	**199,813**	**192,287**	16,979,848	172,438	167,860
– forward and future	**635,628**	**311**	**90**	889,170	142	169
– swaps	**16,488,092**	**194,643**	**188,302**	15,244,353	166,827	162,635
– options purchased	**221,674**	**2,426**	**15**	377,556	3,707	80
– options written	**280,675**	**–**	**2,874**	421,639	–	3,844
– other	**71,035**	**2,433**	**1,006**	47,130	1,762	1,132
Equity derivatives	**827,109**	**29,844**	**33,752**	791,046	30,013	30,959
Credit derivatives	**339,873**	**2,675**	**2,655**	465,174	5,024	4,797
Commodity and other	**82,557**	**999**	**1,771**	68,406	2,409	1,512
Total held for trading	**29,935,832**	**410,874**	**412,937**	28,384,546	378,113	383,503
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**546**	**5**	**–**	546	3	–
Interest rate contracts	**6,573**	**119**	**45**	4,695	128	92
	7,119	**124**	**45**	5,241	131	92
Cash flow hedging derivatives						
Exchange rate contracts	**35,781**	**3,461**	**148**	2,679	–	79
Interest rate contracts	**19,587**	**15**	**22**	41,253	167	31
	55,368	**3,476**	**170**	43,932	167	110
Fair value hedging derivatives						
Interest rate contracts	**51,689**	**65**	**1,632**	53,767	150	1,343
Gross total derivatives	**30,050,008**	**414,539**	**414,784**	28,487,486	378,561	385,048
Netting	**–**	**(22,700)**	**(22,700)**	–	(7,883)	(7,883)
Total	**30,050,008**	**391,839**	**392,084**	28,487,486	370,678	377,165

b *Hedging derivatives*

The group uses derivatives (principally interest rate and currency swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall costs to the group of accessing debt capital markets, and mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

The accounting treatment of hedging transactions varies according to the nature of the instrument hedged and the type of hedging transaction. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or hedges of net investments in foreign operations.

The cash flows of the above hedging derivatives are expected to affect the income statement in 2013 and beyond.

17 Derivatives *(continued)*

Fair value hedges

The group's fair value hedges principally consist 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. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

Gains or losses arising from fair value hedges

	2012 **HK$m**	2011 HK$m
Gains/(losses):		
On hedging instruments	**(376)**	(1,147)
On the hedged items attributable to hedged risk	**345**	1,050
	(31)	(97)

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and currency swaps that are used to protect against exposures to variability in future interest and principal cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their own contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised directly in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2012, the amount transferred to the income statement comprised HK$352m (2011: HK$324m) included in net interest income.

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the year to 31 December 2012, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2011: insignificant amount).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2012 is as follows:

	3 months or less HK$m	**More than 3 months but less than 1 year HK$m**	**5 years or less but more than 1 year HK$m**
At 31 December 2012			
Cash inflows from assets	**43,626**	**50,643**	**37,167**
Cash outflows from liabilities	**(3,661)**	**(2,896)**	**(2,640)**
Net cash inflows	**39,965**	**47,747**	**34,527**
At 31 December 2011			
Cash inflows from assets	80,782	68,488	22,613
Cash outflows from liabilities	(1,022)	(1,656)	(2,406)
Net cash inflows	79,760	66,832	20,207

Notes on the Financial Statements (continued)

17 Derivatives *(continued)*

c *Unobservable inception profits*

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

The table below sets out the aggregate unobservable inception profit yet to be recognised in the income statement at the beginning and end of the year with a reconciliation of the changes during the year.

The group

	2012 HK$m	2011 HK$m
Balance at 1 January	**137**	101
Deferrals on new transactions	**169**	225
Reduction due to amortisation	**(96)**	(86)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	**(89)**	(101)
Exchange differences and others	**3**	(2)
Balance at 31 December	**124**	137

The Bank

	2012 HK$m	2011 HK$m
Balance at 1 January	**124**	91
Deferrals on new transactions	**117**	195
Reduction due to amortisation	**(75)**	(71)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	**(58)**	(89)
Exchange differences and others	**2**	(2)
Balance at 31 December	**110**	124

18 Loans and advances to customers

a *Loans and advances to customers*

	The group		The Bank	
	2012 HK$m	2011 HK$m	**2012 HK$m**	2011 HK$m
Gross loans and advances to customers	**2,358,814**	2,142,172	**1,288,269**	1,184,316
Impairment allowances (note 19(a))	**(9,771)**	(11,301)	**(5,549)**	(7,714)
	2,349,043	2,130,871	**1,282,720**	1,176,602

18 Loans and advances to customers *(continued)*

b *Analysis of loans and advances to customers based on categories used by the HSBC Group*

The following analysis of loans and advances to customers is based on the categories used by the HSBC Group, including the group, to manage associated risks.

The group

2012	**Hong Kong HK$m**	**Rest of Asia-Pacific HK$m**	**Total HK$m**
Residential mortgages[1]	**401,855**	**284,317**	**686,172**
Credit card advances	**45,961**	**33,489**	**79,450**
Other personal	**51,721**	**42,337**	**94,058**
Total personal	**499,537**	**360,143**	**859,680**
Commercial, industrial and international trade	**342,463**	**402,735**	**745,198**
Commercial real estate	**177,339**	**71,925**	**249,264**
Other property-related lending	**127,099**	**51,448**	**178,547**
Government	**21,995**	**8,804**	**30,799**
Other commercial	**96,055**	**133,921**	**229,976**
Total corporate and commercial	**764,951**	**668,833**	**1,433,784**
Non-bank financial institutions	**31,545**	**30,263**	**61,808**
Settlement accounts	**3,031**	**511**	**3,542**
Total financial	**34,576**	**30,774**	**65,350**
Gross loans and advances to customers	**1,299,064**	**1,059,750**	**2,358,814**
Individually assessed impairment allowances	**(1,418)**	**(3,827)**	**(5,245)**
Collectively assessed impairment allowances	**(2,167)**	**(2,359)**	**(4,526)**
Net loans and advances to customers	**1,295,479**	**1,053,564**	**2,349,043**
2011			
Residential mortgages[1]	360,368	247,767	608,135
Credit card advances	41,200	31,849	73,049
Other personal	51,339	38,093	89,432
Total personal	452,907	317,709	770,616
Commercial, industrial and international trade	295,729	365,579	661,308
Commercial real estate	158,222	74,041	232,263
Other property-related lending	134,910	49,659	184,569
Government	22,669	7,471	30,140
Other commercial	96,398	117,205	213,603
Total corporate and commercial	707,928	613,955	1,321,883
Non-bank financial institutions	24,799	23,300	48,099
Settlement accounts	1,236	338	1,574
Total financial	26,035	23,638	49,673
Gross loans and advances to customers	1,186,870	955,302	2,142,172
Individually assessed impairment allowances	(2,174)	(4,720)	(6,894)
Collectively assessed impairment allowances	(2,254)	(2,153)	(4,407)
Net loans and advances to customers	1,182,442	948,429	2,130,871

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$24,426m (2011: HK$25,640m).*

Notes on the Financial Statements (continued)

18 Loans and advances to customers *(continued)*

The Bank

2012	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
Residential mortgages[1]	**244,780**	**111,721**	**356,501**
Credit card advances	**25,557**	**12,198**	**37,755**
Other personal	**32,314**	**21,468**	**53,782**
Total personal	**302,651**	**145,387**	**448,038**
Commercial, industrial and international trade	**235,972**	**171,735**	**407,707**
Commercial real estate	**113,958**	**33,314**	**147,272**
Other property-related lending	**45,402**	**21,682**	**67,084**
Government	**21,814**	**2,786**	**24,600**
Other commercial	**66,809**	**81,040**	**147,849**
Total corporate and commercial	**483,955**	**310,557**	**794,512**
Non-bank financial institutions	**28,771**	**16,814**	**45,585**
Settlement accounts	**–**	**134**	**134**
Total financial	**28,771**	**16,948**	**45,719**
Gross loans and advances to customers	**815,377**	**472,892**	**1,288,269**
Individually assessed impairment allowances	**(903)**	**(1,994)**	**(2,897)**
Collectively assessed impairment allowances	**(1,579)**	**(1,073)**	**(2,652)**
Net loans and advances to customers	**812,895**	**469,825**	**1,282,720**
2011			
Residential mortgages[1]	222,219	95,004	317,223
Credit card advances	22,653	11,966	34,619
Other personal	32,651	18,684	51,335
Total personal	277,523	125,654	403,177
Commercial, industrial and international trade	207,990	166,072	374,062
Commercial real estate	113,104	36,160	149,264
Other property-related lending	43,206	23,190	66,396
Government	22,124	2,166	24,290
Other commercial	66,345	66,804	133,149
Total corporate and commercial	452,769	294,392	747,161
Non-bank financial institutions	21,256	12,607	33,863
Settlement accounts	–	115	115
Total financial	21,256	12,722	33,978
Gross loans and advances to customers	751,548	432,768	1,184,316
Individually assessed impairment allowances	(1,377)	(3,608)	(4,985)
Collectively assessed impairment allowances	(1,633)	(1,096)	(2,729)
Net loans and advances to customers	748,538	428,064	1,176,602

The geographical information shown above has been classified by the location of the principal operations of the subsidiary or, in the case of the Bank, by the location of the branch responsible for advancing the funds.

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$10,540m (2011: HK$11,235m).*

18 Loans and advances to customers *(continued)*

c *Loans and advances to customers include equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases*

The group

	2012			2011		
	Present value of the minimum lease payments HK$m	**Unearned future finance income HK$m**	**Total minimum lease payments HK$m**	Present value of the minimum lease payments HK$m	Unearned future finance income HK$m	Total minimum lease payments HK$m
Amounts receivable						
– Within one year	**2,965**	**684**	**3,649**	3,022	686	3,708
– After one year but within five years	**7,667**	**2,005**	**9,672**	7,241	1,701	8,942
– After five years	**14,506**	**2,042**	**16,548**	13,198	1,661	14,859
	25,138	**4,731**	**29,869**	23,461	4,048	27,509
Impairment allowances	**(47)**			(54)		
Net investment in finance leases and hire purchase contracts	**25,091**			23,407		

The Bank

	2012			2011		
	Present value of the minimum lease payments HK$m	**Unearned future finance income HK$m**	**Total minimum lease payments HK$m**	Present value of the minimum lease payments HK$m	Unearned future finance income HK$m	Total minimum lease payments HK$m
Amounts receivable						
– Within one year	**1,590**	**321**	**1,911**	1,640	272	1,912
– After one year but within five years	**4,058**	**924**	**4,982**	3,938	764	4,702
– After five years	**10,217**	**1,586**	**11,803**	8,871	1,207	10,078
	15,865	**2,831**	**18,696**	14,449	2,243	16,692
Impairment allowances	**(9)**			(10)		
Net investment in finance leases and hire purchase contracts	**15,856**			14,439		

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers

a *Impairment allowances against loans and advances to customers*

The group

2012	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**6,894**	**4,407**	**11,301**
Amounts written off	**(2,730)**	**(3,597)**	**(6,327)**
Recoveries of loans and advances written off in previous years	**237**	**1,166**	**1,403**
Net charge to income statement (note 4(i))	**734**	**2,596**	**3,330**
Unwinding of discount of loan impairment	**(57)**	**(94)**	**(151)**
Exchange and other adjustments	**167**	**48**	**215**
At 31 December (note 18(a))	**5,245**	**4,526**	**9,771**
2011			
At 1 January	8,259	4,735	12,994
Amounts written off	(2,150)	(3,792)	(5,942)
Recoveries of loans and advances written off in previous years	356	1,448	1,804
Net charge to income statement (note 4(i))	694	2,401	3,095
Unwinding of discount of loan impairment	(78)	(216)	(294)
Exchange and other adjustments	(187)	(169)	(356)
At 31 December (note 18(a))	6,894	4,407	11,301

The Bank

2012	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**4,985**	**2,729**	**7,714**
Amounts written off	**(2,236)**	**(1,833)**	**(4,069)**
Recoveries of loans and advances written off in previous years	**71**	**542**	**613**
Net charge to income statement	**162**	**1,223**	**1,385**
Unwinding of discount of loan impairment	**(42)**	**(41)**	**(83)**
Exchange and other adjustments	**(43)**	**32**	**(11)**
At 31 December (note 18(a))	**2,897**	**2,652**	**5,549**
2011			
At 1 January	5,946	3,027	8,973
Amounts written off	(1,545)	(2,216)	(3,761)
Recoveries of loans and advances written off in previous years	198	845	1,043
Net charge to income statement	612	1,358	1,970
Unwinding of discount of loan impairment	(53)	(149)	(202)
Exchange and other adjustments	(173)	(136)	(309)
At 31 December (note 18(a))	4,985	2,729	7,714

19 Impairment allowances against loans and advances to customers *(continued)*

b *Impairment allowances on loans and advances to customers*

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. Individually assessed allowances are made after taking into account the value of collateral in respect of such loans and advances.

The geographical information shown below has been classified by the location of the principal operations of the subsidiary or, in the case of the Bank, by the location of the branch responsible for advancing the funds.

The group

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2012			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	**2,927**	**8,467**	**11,394**
Collectively assessed	**1,296,137**	**1,051,283**	**2,347,420**
– Impaired loans and advances	**621**	**999**	**1,620**
– Non-impaired loans and advances	**1,295,516**	**1,050,284**	**2,345,800**
Total gross loans and advances to customers	**1,299,064**	**1,059,750**	**2,358,814**
Impairment allowances	**(3,585)**	**(6,186)**	**(9,771)**
– Individually assessed	**(1,418)**	**(3,827)**	**(5,245)**
– Collectively assessed	**(2,167)**	**(2,359)**	**(4,526)**
Net loans and advances	**1,295,479**	**1,053,564**	**2,349,043**
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**1,264**	**3,790**	**5,054**
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	**0.2%**	**0.8%**	**0.5%**
Total allowances as a percentage of total gross loans and advances	**0.3%**	**0.6%**	**0.4%**
At 31 December 2011			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	3,881	8,490	12,371
Collectively assessed	1,182,989	946,812	2,129,801
– Impaired loans and advances	657	823	1,480
– Non-impaired loans and advances	1,182,332	945,989	2,128,321
Total gross loans and advances to customers	1,186,870	955,302	2,142,172
Impairment allowances	(4,428)	(6,873)	(11,301)
– Individually assessed	(2,174)	(4,720)	(6,894)
– Collectively assessed	(2,254)	(2,153)	(4,407)
Net loans and advances	1,182,442	948,429	2,130,871
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,403	3,252	4,655
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.3%	0.9%	0.6%
Total allowances as a percentage of total gross loans and advances	0.4%	0.7%	0.5%

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers *(continued)*

The Bank

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2012			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	**1,963**	**3,754**	**5,717**
Collectively assessed	**813,414**	**469,138**	**1,282,552**
– Impaired loans and advances	**471**	**360**	**831**
– Non-impaired loans and advances	**812,943**	**468,778**	**1,281,721**
Total gross loans and advances to customers	**815,377**	**472,892**	**1,288,269**
Impairment allowances	**(2,482)**	**(3,067)**	**(5,549)**
– Individually assessed	**(903)**	**(1,994)**	**(2,897)**
– Collectively assessed	**(1,579)**	**(1,073)**	**(2,652)**
Net loans and advances	**812,895**	**469,825**	**1,282,720**
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**925**	**1,032**	**1,957**
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	**0.2%**	**0.8%**	**0.4%**
Total allowances as a percentage of total gross loans and advances	**0.3%**	**0.6%**	**0.4%**
At 31 December 2011			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	2,520	5,472	7,992
Collectively assessed	749,028	427,296	1,176,324
– Impaired loans and advances	566	393	959
– Non-impaired loans and advances	748,462	426,903	1,175,365
Total gross loans and advances to customers	751,548	432,768	1,184,316
Impairment allowances	(3,010)	(4,704)	(7,714)
– Individually assessed	(1,377)	(3,608)	(4,985)
– Collectively assessed	(1,633)	(1,096)	(2,729)
Net loans and advances	748,538	428,064	1,176,602
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,032	1,167	2,199
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.3%	1.3%	0.7%
Total allowances as a percentage of total gross loans and advances	0.4%	1.1%	0.7%

19 Impairment allowances against loans and advances to customers *(continued)*

For individually assessed customer loans and advances where the industry sector comprises not less than 10% of the group's total gross loans and advances to customers, the analysis of gross impaired loans and advances and allowances by major industry sectors based on categories and definitions used by the HSBC Group is as follows:

The group

	Total gross loans and advances HK$m	Gross impaired advances HK$m	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Net new impairment allowances HK$m	Advances written-off in year HK$m
At 31 December 2012						
Residential mortgages	**686,172**	**2,485**	**(428)**	**(122)**	**67**	**59**
Commercial, industrial and international trade	**745,198**	**5,117**	**(2,897)**	**(2,060)**	**140**	**2,410**
Commercial real estate	**249,264**	**533**	**(413)**	**(107)**	**226**	**59**
At 31 December 2011						
Residential mortgages	608,135	2,369	(372)	(166)	29	47
Commercial, industrial and international trade	661,308	6,970	(5,184)	(2,049)	919	1,435
Commercial real estate	232,263	580	(268)	(69)	134	47

The Bank

	Total gross loans and advances HK$m	Gross impaired advances HK$m	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Net new impairment allowances HK$m	Advances written-off in year HK$m
At 31 December 2012						
Residential mortgages	**356,501**	**620**	**(101)**	**(38)**	**(1)**	**23**
Commercial, industrial and international trade	**407,707**	**2,932**	**(1,694)**	**(1,292)**	**(91)**	**2,063**
Commercial real estate	**147,272**	**335**	**(281)**	**(68)**	**223**	**1**
At 31 December 2011						
Residential mortgages	317,223	598	(98)	(72)	7	8
Commercial, industrial and international trade	374,062	5,115	(3,897)	(1,256)	703	999
Commercial real estate	149,264	357	(117)	(32)	84	4

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

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers *(continued)*

c *Overdue and rescheduled loans and advances to customers*

The group

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
At 31 December 2012						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– more than three months but less than six months	**288**	**0.0**	**1,733**	**0.2**	**2,021**	**0.1**
– more than six months but less than one year	**166**	**0.0**	**1,283**	**0.1**	**1,449**	**0.1**
– more than one year	**1,856**	**0.1**	**2,828**	**0.3**	**4,684**	**0.2**
	2,310	**0.1**	**5,844**	**0.6**	**8,154**	**0.4**
Individually assessed impairment allowances made in respect of amounts overdue	**(895)**		**(3,008)**		**(3,903)**	
Fair value of collateral held in respect of amounts overdue	**769**		**2,285**		**3,054**	
Rescheduled loans and advances to customers	**565**	**0.0**	**2,781**	**0.3**	**3,346**	**0.1**
At 31 December 2011						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– more than three months but less than six months	616	0.1	3,446	0.4	4,062	0.2
– more than six months but less than one year	234	0.0	720	0.1	954	0.0
– more than one year	1,807	0.2	2,880	0.3	4,687	0.2
	2,657	0.3	7,046	0.8	9,703	0.4
Individually assessed impairment allowances made in respect of amounts overdue	(1,614)		(4,106)		(5,720)	
Fair value of collateral held in respect of amounts overdue	825		2,030		2,855	
Rescheduled loans and advances to customers	1,257	0.1	1,938	0.2	3,195	0.1

19 Impairment allowances against loans and advances to customers *(continued)*

The Bank

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
At 31 December 2012						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– more than three months but less than six months	**189**	**0.0**	**427**	**0.1**	**616**	**0.1**
– more than six months but less than one year	**109**	**0.0**	**303**	**0.1**	**412**	**0.0**
– more than one year	**1,272**	**0.2**	**1,489**	**0.3**	**2,761**	**0.2**
	1,570	**0.2**	**2,219**	**0.5**	**3,789**	**0.3**
Individually assessed impairment allowances made in respect of amounts overdue	**(551)**		**(1,357)**		**(1,908)**	
Fair value of collateral held in respect of amounts overdue	**681**		**501**		**1,182**	
Rescheduled loans and advances to customers	**427**	**0.1**	**1,234**	**0.3**	**1,661**	**0.1**
At 31 December 2011						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– more than three months but less than six months	390	0.1	2,315	0.5	2,705	0.2
– more than six months but less than one year	181	0.0	270	0.1	451	0.0
– more than one year	1,131	0.2	1,780	0.4	2,911	0.3
	1,702	0.3	4,365	1.0	6,067	0.5
Individually assessed impairment allowances made in respect of amounts overdue	(871)		(3,090)		(3,961)	
Fair value of collateral held in respect of amounts overdue	675		643		1,318	
Rescheduled loans and advances to customers	1,149	0.2	543	0.1	1,692	0.1

Rescheduled loans and advances to customers are those loans and advances which have been restructured or renegotiated because of deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule. Rescheduled loans and advances to customers are stated net of any loans and advances which have subsequently become overdue for more than three months and which are included in 'Overdue and rescheduled loans and advances to customers'.

20 Impairment and rescheduled amounts relating to loans and advances to banks and other assets

There are no significant impaired or rescheduled loans and advances to banks or overdue or rescheduled other assets as at 31 December 2012 and 31 December 2011. Information relating to overdue balances can be found in note 52.

Notes on the Financial Statements (continued)

21 Financial investments

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Debt securities				
– held-to-maturity	**155,393**	134,720	**–**	–
– available-for-sale	**463,278**	542,536	**257,804**	325,136
Equity shares				
– available-for-sale	**7,371**	45,177	**2,513**	37,171
	626,042	722,433	**260,317**	362,307
Financial investments				
– which may be repledged or resold by counterparties	**985**	847	**897**	325
– not subject to repledge or resale by counterparties	**625,057**	721,586	**259,420**	361,982
	626,042	722,433	**260,317**	362,307

a *Held-to-maturity debt securities*

The group

	Book value		Fair value	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**4,174**	2,932	**4,644**	3,209
– listed outside Hong Kong	**39,217**	31,017	**42,814**	32,847
	43,391	33,949	**47,458**	36,056
Unlisted	**112,002**	100,771	**119,873**	106,618
	155,393	134,720	**167,331**	142,674
Issued by public bodies				
– central governments and central banks	**3,538**	2,551	**4,189**	3,049
– other public sector entities	**20,660**	20,703	**22,646**	22,347
	24,198	23,254	**26,835**	25,396
Issued by				
– banks	**75,744**	72,303	**80,819**	75,309
– corporate entities	**55,451**	39,163	**59,677**	41,969
	155,393	134,720	**167,331**	142,674

21 Financial Investments *(continued)*

b *Available-for-sale debt securities*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**21,587**	23,333	**5,235**	2,872
– listed outside Hong Kong	**166,320**	169,312	**126,066**	131,216
	187,907	192,645	**131,301**	134,088
Unlisted	**275,371**	349,891	**126,503**	191,048
	463,278	542,536	**257,804**	325,136
Issued by public bodies				
– central governments and central banks	**263,466**	295,436	**158,035**	182,580
– other public sector entities	**70,715**	78,901	**41,214**	51,118
	334,181	374,337	**199,249**	233,698
Issued by				
– banks	**94,758**	136,388	**46,467**	74,434
– corporate entities	**34,339**	31,811	**12,088**	17,004
	463,278	542,536	**257,804**	325,136

c *Available-for-sale equity shares*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**663**	31,794	**–**	31,372
– listed outside Hong Kong	**26**	129	**15**	89
	689	31,923	**15**	31,461
Unlisted	**6,682**	13,254	**2,498**	5,710
	7,371	45,177	**2,513**	37,171
Issued by				
– banks	**42**	7,140	**31**	3,716
– corporate entities	**7,329**	38,037	**2,482**	33,455
	7,371	45,177	**2,513**	37,171

22 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 (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) securities lent under securities lending agreements.

As the substance of these transactions is secured borrowings the asset collateral continues to be recognised in full and the related liability reflecting the group's obligation to repurchase the transferred assets for a fixed price at a future date is recognised in deposits by banks or customer accounts as appropriate. As a result of these transactions, the group is unable to use, sell or pledge the transferred assets for the duration of the transaction. The group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparty's recourse is not limited to the transferred assets.

The following table analyses the carrying amount of financial assets that did not qualify for derecognition and their associated liabilities.

Financial assets and associated financial liabilities not qualifying for full derecognition

The group

	2012		2011	
	Carrying amount of transferred assets HK$m	**Carrying amount of associated liabilities HK$m**	Carrying amount of transferred assets HK$m	Carrying amount of associated liabilities HK$m
Repurchase agreements	**15,223**	**15,202**	33,961	33,675
Securities lending agreements	**2,090**	**2,085**	4,269	3,793
	17,313	**17,287**	38,230	37,468

The Bank

	2012		2011	
	Carrying amount of transferred assets HK$m	**Carrying amount of associated liabilities HK$m**	Carrying amount of transferred assets HK$m	Carrying amount of associated liabilities HK$m
Repurchase agreements	**26,415**	**26,451**	19,281	19,350
Securities lending agreements	**2,002**	**2,085**	4,113	3,793
	28,417	**28,536**	23,394	23,143

23 Investments in subsidiaries

	The Bank	
	2012	2011
	HK$m	HK$m
Investments in subsidiaries:		
Unlisted investments	**57,954**	56,859
Listed investment	**865**	865
	58,819	57,724

The principal subsidiaries of the Bank are:

	Place of incorporation	**Principal activity**	**Nominal value of issued share capital / registered capital**	**Class of share / registered capital**	**The group's interest in issued share capital / registered capital**
Hang Seng Bank Limited	Hong Kong	Banking	HK$9,559m	Ordinary	62.14%
HSBC Bank (China) Company Limited	PRC[1]	Banking	RMB12,400m	Ordinary	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	RM$115m	Ordinary	100%
HSBC Bank Australia Limited[2]	Australia	Banking	A$751m	Ordinary	100%
			A$60m	Preference	100%
HSBC Bank (Taiwan) Limited[2]	Taiwan	Banking	TWD30,000m	Ordinary	100%
HSBC Insurance (Asia) Limited[2]	Hong Kong	Insurance	HK$2,798m	Ordinary	100%
HSBC Life (International) Limited[2]	Bermuda	Retirement benefits and life insurance	HK$2,778m	Ordinary	100%

1 *People's Republic of China*
2 *Held indirectly*

The principal countries of operation are the same as the countries of incorporation except for HSBC Life (International) Limited which operates mainly in Hong Kong.

All of the above companies are controlled subsidiaries and have been consolidated in the financial statements.

The principal subsidiaries are regulated banking and insurance entities and, as such, are required to maintain certain minimum levels of capital and liquid assets to support their operations. The effect of these regulatory requirements is to limit the extent to which the subsidiaries may transfer funds to the Bank in the form of repayment of shareholder loans or cash dividends.

Notes on the Financial Statements (continued)

24 Interests in associates and joint ventures

	The group 2012 HK$m	2011 HK$m
Share of net assets	**113,415**	84,493
Goodwill	**5,191**	5,544
Intangible assets	**1,409**	2,216
Deferred tax on intangible assets	**(347)**	(468)
Impairment	**(395)**	–
	119,273	91,785

At 31 December 2012, the group's interests in associates amounted to HK$117,946m (2011: HK$90,130m).

	The Bank 2012 HK$m	2011 HK$m
Listed investments	**39,824**	26,561
Unlisted investments	**1,095**	1,578
	40,919	28,139

Shareholdings in associates held by the Bank include listed investments of HK$39,824m (2011: HK$26,561m). As at the balance sheet date, the fair value of these investments held by the group, based on quoted market prices, was HK$110,820m (2011: HK$87,107m).

a *Principal associates*

The principal associates of the group are:

	At 31 December 2012		At 31 December 2011	
	Carrying value HK$m	**Fair value HK$m**	Carrying value HK$m	Fair value HK$m
Listed				
Bank of Communications Co., Ltd.	**91,840**	**82,411**	66,704	63,964
Industrial Bank Co., Ltd.[3]	**22,099**	**28,409**	17,199	21,307
Bao Viet Holdings[3]	**–**	**–**	1,409	1,836
	113,939	**110,820**	85,312	87,107

	Place of incorporation	**Principal activity**	**Nominal value of issued share capital / registered capital**	**Class of share / registered capital**	**The group's interest in issued share capital / registered capital**
Listed					
Bank of Communications Co., Ltd.	PRC[1]	Banking	RMB74,263m	Ordinary	19.03%
Industrial Bank Co., Ltd.[3]	PRC[1]	Banking	RMB10,786m	Ordinary	12.80%
Unlisted					
Barrowgate Limited[3]	Hong Kong	Property investment	–[2]	Ordinary	24.64%
Vietnam Technological and Commercial Joint Stock Bank	Vietnam	Banking	VND8,848bn	Ordinary	19.48%
Yantai Bank Co., Limited[3]	PRC[1]	Banking	RMB2,000m	Ordinary	20.00%

1 *People's Republic of China*
2 *Nominal value of issued share capital is less than HK$1m*
3 *Held indirectly*

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

24 Interests in associates and joint ventures *(continued)*

The group's interests in Bank of Communications Co., Ltd. ('BoCom') and Vietnam Technological and Commercial Joint Stock Bank ('TechCom Bank') are accounted for as associates as the group has representation on the Board of Directors of each, whilst for BoCom, the Bank also has representation on the strategy committee. The group has entered into Technical Support and Assistance Agreements with BoCom, TechCom Bank, Hana HSBC Life Insurance and Canara HSBC Oriental Bank of Commerce Life Insurance to provide technical support and assistance in relation to their banking and insurance business.

Until 20 December 2012, the group's interest in Bao Viet Holdings ('Bao Viet') was accounted for as an associate as the group had representation on the Board of Directors. On 20 December 2012, the group announced that it had entered into an agreement to sell its entire 18% shareholding in Bao Viet to Sumitomo Life Insurance Company, a transaction which is expected to complete during the first quarter of 2013. At 31 December 2012, the group's interest in Bao Viet was classified as 'Held For Sale'.

For the year ended 31 December 2012, Hang Seng Bank Limited's ('Hang Seng') interest in Industrial Bank Co., Ltd. ('Industrial Bank') was accounted for as an associate as Hang Seng had representation on the Board of Directors and the executive committee. 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 it is no longer in a position to exercise significant influence over Industrial Bank and ceased to account for the investment as an associate from that date. Thereafter, the holding is recognised as an available-for-sale financial investment.

In respect of the year ended 31 December 2012, BoCom, Industrial Bank, TechCom Bank and Bao Viet were included in these financial statements based on financial statements drawn up to 30 September 2012, but taking into account the financial effect of significant transactions or events in the subsequent period from 1 October 2012 to 31 December 2012. The group has taken advantage of the provision contained in HKAS 28 'Investments in Associates' whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference is no greater than three months.

Interests in associates include intangible assets recognised on acquisition with respect to customer relationships and brand names which are amortised over a period of 10 years.

During 2012, the market value of the investment in BoCom had been below the carrying amount in the group's consolidated balance sheet for a period of approximately ten months. An impairment test was performed as at 31 December 2012 on the carrying amount of the investment in BoCom.

The result confirmed that there was no impairment. The impairment test was performed by comparing the recoverable amount of BoCom, determined by a value in use ('VIU') calculation, with its carrying amount. The calculation of VIU used discounted cash flow projections based on management's estimates. Cash flows beyond the next five years were then extrapolated in perpetuity using a long-term growth rate. The discount rate used was based on a cost of capital used to evaluate investments in mainland China.

Management judgement is required in estimating the future cash flows of BoCom. These values are sensitive to the cash flows projected in the short and medium term, and also to the key assumptions regarding the long term sustainable cash flows thereafter. The key assumptions are consistent with external sources of information.

Notes on the Financial Statements (continued)

24 Interests in associates and joint ventures *(continued)*

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

	Assets HK$m	Liabilities HK$m	Equity HK$m	Revenue HK$m	Expenses HK$m	Profit HK$m
2012						
100%	**10,184,199**	**9,539,491**	**644,708**	**290,621**	**176,997**	**113,624**
The group's effective interest[1]	**1,537,471**	**1,433,597**	**103,874**	**44,579**	**27,476**	**17,103**
2011						
100%	8,127,975	7,647,933	480,042	223,952	133,979	89,973
The group's effective interest[1]	1,265,356	1,188,011	77,345	36,318	22,342	13,976

1 *The group's effective interest is stated net of non-controlling interests.*

At 31 December 2012, the group's share of associates and joint ventures' contingent liabilities was HK$357,664m (2011: HK$266,530m).

c *The principal joint ventures of the group are:*

	Place of incorporation	Principal activity	Nominal value of issued share capital	Class of share	The group's interest in issued share capital
Listed					
Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited	India	Insurance manufacturing	INR9,500m	Ordinary	26.00%
Hana HSBC Life Insurance Co., Ltd	South Korea	Insurance manufacturing	KRW110,201m	Ordinary	49.99%

25 Goodwill and intangible assets

Goodwill and intangible assets includes goodwill arising on business combinations, the present value of in-force long-term insurance business, and other intangible assets.

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Goodwill	**7,237**	7,629	**1,180**	1,177
Present value of in-force long-term insurance business	**24,425**	20,232	**–**	–
Other intangible assets	**6,972**	6,978	**3,585**	3,654
	38,634	34,839	**4,765**	4,831

a *Goodwill*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Cost at 1 January	**7,629**	7,891	**1,177**	1,167
Disposals	**(67)**	–	**(2)**	–
Exchange and other movements	**(325)**	(262)	**5**	10
Net book value at 31 December	**7,237**	7,629	**1,180**	1,177

Segmental analysis of goodwill

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong – Retail Banking and Wealth Management	**–**	12	**–**	–
Hong Kong – Commercial Banking	**24**	36	**24**	24
Hong Kong – Global Banking and Markets	**750**	755	**498**	498
Rest of Asia-Pacific – Retail Banking and Wealth Management	**1,192**	1,430	**80**	78
Rest of Asia-Pacific – Commercial Banking	**4,184**	4,275	**–**	–
Rest of Asia-Pacific – Global Banking and Markets	**1,087**	1,121	**578**	577
Total goodwill in the CGUs listed	**7,237**	7,629	**1,180**	1,177

During 2012 there was no impairment of goodwill (2011: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs'), determined at 1 July 2012 based on a value in use calculation, with the carrying amount of the CGUs. That calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current Gross Domestic Product for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of business units making up the CGUs. The discount rate used is based on the cost of capital HSBC allocates to investments in the countries in which the CGU operates.

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

25 Goodwill and intangible assets *(continued)*

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

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the nominal long-term growth rate. The discount rates used in the impairment test in 2012 was 11% (2011: in the range of 10% to 11%) across different CGUs. The nominal long-term growth rates used in the impairment test in 2012 for Hong Kong and Rest of Asia-Pacific were 4.7% and 5.0% respectively (2011: 7.9% and 7.8%).

b *The present value of in-force long-term insurance business ('PVIF')*

(i) PVIF specific assumptions

The following are the key assumptions used in the computation of PVIF for Hong Kong, being the main life insurance operation:

	2012	2011
Risk free rate	**0.60%**	1.47%
Risk discount rate	**7.46%**	8.00%
Expenses inflation	**3.00%**	3.00%
Lapse rate	**0%-20% for all years**	0%-20% for the first policy year and 0%-15% for renewal years

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

	The group	
	2012	2011
	HK$m	HK$m
At 1 January	**20,232**	14,767
Value of new business written during the year	**5,559**	4,982
Movements arising from in-force business:		
– expected return	**(1,077)**	(1,277)
– experience variances	**162**	55
– changes in operating assumptions	**(153)**	(748)
Investment return variances	**(94)**	(232)
Changes in investment assumptions	**133**	1,871
Other adjustments	**(98)**	873
Changes in PVIF of long-term insurance business	**4,432**	5,524
Exchange differences and other	**(239)**	(59)
At 31 December	**24,425**	20,232

25 Goodwill and intangible assets *(continued)*

c *Other intangible assets*

The group

	2012			
	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other[1] HK$m**	**Total HK$m**
Cost				
At 1 January	**9,776**	**1,889**	**2,253**	**13,918**
Additions	**1,303**	**–**	**–**	**1,303**
Disposals/amounts written-off	**(208)**	**(30)**	**–**	**(238)**
Exchange and other movements	**650**	**(17)**	**114**	**747**
At 31 December	**11,521**	**1,842**	**2,367**	**15,730**
Accumulated amortisation and impairment				
At 1 January	**5,991**	**915**	**34**	**6,940**
Amortisation charge for the year	**1,398**	**164**	**16**	**1,578**
Impairment	**130**	**–**	**16**	**146**
Disposals/amounts written-off	**(193)**	**(31)**	**–**	**(224)**
Exchange and other movements	**327**	**(9)**	**–**	**318**
At 31 December	**7,653**	**1,039**	**66**	**8,758**
Net book value at 31 December	**3,868**	**803**	**2,301**	**6,972**

	2011			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other[1] HK$m	Total HK$m
Cost				
At 1 January	8,208	1,905	2,318	12,431
Additions	1,767	–	37	1,804
Disposals/amounts written-off	(173)	(2)	(4)	(179)
Exchange and other movements	(26)	(14)	(98)	(138)
At 31 December	9,776	1,889	2,253	13,918
Accumulated amortisation and impairment				
At 1 January	4,640	727	32	5,399
Amortisation charge for the year	1,283	202	11	1,496
Impairment	264	–	–	264
Disposals/amounts written-off	(173)	(2)	(4)	(179)
Exchange and other movements	(23)	(12)	(5)	(40)
At 31 December	5,991	915	34	6,940
Net book value at 31 December	3,785	974	2,219	6,978

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

Notes on the Financial Statements (continued)

25 Goodwill and intangible assets *(continued)*

The Bank

	2012			
	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other HK$m**	**Total HK$m**
Cost				
At 1 January	**7,715**	**1,264**	**44**	**9,023**
Additions	**908**	**–**	**–**	**908**
Disposals/amounts written-off	**(170)**	**–**	**–**	**(170)**
Exchange and other movements	**596**	**22**	**34**	**652**
At 31 December	**9,049**	**1,286**	**78**	**10,413**
Accumulated amortisation and impairment				
At 1 January	**4,760**	**604**	**5**	**5,369**
Amortisation charge for the year	**1,111**	**105**	**24**	**1,240**
Impairment	**75**	**–**	**–**	**75**
Disposals/amounts written-off	**(169)**	**–**	**–**	**(169)**
Exchange and other movements	**302**	**10**	**1**	**313**
At 31 December	**6,079**	**719**	**30**	**6,828**
Net book value at 31 December	**2,970**	**567**	**48**	**3,585**

	2011			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other HK$m	Total HK$m
Cost				
At 1 January	6,424	1,269	12	7,705
Additions	1,371	–	37	1,408
Disposals/amounts written-off	(74)	(2)	(5)	(81)
Exchange and other movements	(6)	(3)	–	(9)
At 31 December	7,715	1,264	44	9,023
Accumulated amortisation and impairment				
At 1 January	3,647	503	9	4,159
Amortisation charge for the year	1,019	105	1	1,125
Impairment	173	–	–	173
Disposals/amounts written-off	(74)	(2)	(5)	(81)
Exchange and other movements	(5)	(2)	–	(7)
At 31 December	4,760	604	5	5,369
Net book value at 31 December	2,955	660	39	3,654

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

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

25 Goodwill and intangible assets *(continued)*

An impairment test was carried out in respect of the operating licenses in Taiwan as at 1 July 2012. The result confirmed that there was no impairment. The impairment test was performed by comparing the recoverable amount of the relevant cash generating units ('CGUs'), determined by a value in use calculation, with the carrying amounts of the CGUs. The calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a long-term growth rate applicable to the banking industry in Taiwan. The discount rate used is based on the cost of capital the group allocates to Taiwan.

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

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

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the long-term growth rate. The discount rate used during 2012 was 13% (2011: in the range of 12% to 13%). The long-term growth rate used in the impairment testing during 2012 was 3% (2011: 3%).

26 Property, plant and equipment

a *Property, plant and equipment*

	The group			The Bank		
	Land and buildings HK$m	Investment properties HK$m	Equipment HK$m	Land and buildings HK$m	Investment properties HK$m	Equipment HK$m
Cost or valuation						
At 1 January 2012	75,090	4,616	21,922	48,318	147	13,862
Exchange and other adjustments	(159)	–	62	(177)	–	(2)
Additions	240	–	1,750	234	–	1,033
Disposals	(2)	–	(824)	(1)	–	(393)
Elimination of accumulated depreciation on revalued land and buildings	(1,857)	–	–	(1,106)	–	–
Surplus on revaluation	7,223	834	–	3,636	50	–
Reclassifications	(431)	(168)	(682)	(9)	–	(628)
At 31 December 2012	80,104	5,282	22,228	50,895	197	13,872
Accumulated depreciation						
At 1 January 2012	21	–	16,313	–	–	10,451
Exchange and other adjustments	1	–	52	1	–	(1)
Charge for the year	1,897	–	2,117	1,162	–	1,299
Disposals	–	–	(772)	–	–	(366)
Elimination of accumulated depreciation on revalued land and buildings	(1,857)	–	–	(1,106)	–	–
Reclassifications	(2)	–	(335)	–	–	(328)
At 31 December 2012	60	–	17,375	57	–	11,055
Net book value at 31 December 2012	80,044	5,282	4,853	50,838	197	2,817
Total at 31 December 2012			90,179			53,852

Notes on the Financial Statements (continued)

26 Property, plant and equipment *(continued)*

	The group			The Bank		
	Land and buildings HK$m	Investment properties HK$m	Equipment HK$m	Land and buildings HK$m	Investment properties HK$m	Equipment HK$m
Cost or valuation						
At 1 January 2011	63,148	3,503	20,530	41,423	126	13,149
Exchange and other adjustments	11	–	(212)	(9)	–	(222)
Additions	545	–	2,325	505	–	1,397
Disposals	(7)	–	(697)	(3)	–	(456)
Elimination of accumulated depreciation on revalued land and buildings	(1,593)	–	–	(1,001)	–	–
Surplus on revaluation	12,948	1,033	–	7,477	21	–
Reclassifications	38	80	(24)	(74)	–	(6)
At 31 December 2011	75,090	4,616	21,922	48,318	147	13,862
Accumulated depreciation						
At 1 January 2011	2	–	14,832	–	–	9,637
Exchange and other adjustments	–	–	(181)	–	–	(182)
Charge for the year	1,615	–	2,263	1,004	–	1,382
Disposals	(3)	–	(599)	(3)	–	(384)
Elimination of accumulated depreciation on revalued land and buildings	(1,593)	–	–	(1,001)	–	–
Reclassifications	–	–	(2)	–	–	(2)
At 31 December 2011	21	–	16,313	–	–	10,451
Net book value at 31 December 2011	75,069	4,616	5,609	48,318	147	3,411
Total at 31 December 2011			85,294			51,876

b *The carrying amount of land and buildings, had they been stated at cost less accumulated depreciation, would have been as follows:*

	The group		The Bank	
	2012 HK$m	2011 HK$m	**2012 HK$m**	2011 HK$m
Cost less accumulated depreciation	**18,847**	19,575	**14,031**	14,541

c *An analysis of land and buildings carried at valuation or cost (before deduction of accumulated depreciation) is as follows:*

	The group		The Bank	
	2012 HK$m	2011 HK$m	**2012 HK$m**	2011 HK$m
Land and buildings carried at valuation	**80,094**	74,901	**50,895**	48,318
Other land and buildings stated at cost	**10**	189	**–**	–
Land and buildings before deduction of accumulated depreciation	**80,104**	75,090	**50,895**	48,318

26 Property, plant and equipment *(continued)*

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

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Long leaseholds (over fifty years)	**35,604**	34,787	**30,216**	29,818
Medium-term leaseholds (between ten and fifty years)	**38,716**	34,182	**11,985**	10,004
Short leaseholds (less than ten years)	**76**	90	**76**	90
	74,396	69,059	**42,277**	39,912
Outside Hong Kong:				
Freehold	**4,562**	4,444	**3,537**	3,489
Long leaseholds (over fifty years)	**174**	157	**126**	112
Medium-term leaseholds (between ten and fifty years)	**6,157**	5,978	**5,058**	4,905
Short leaseholds (less than ten years)	**37**	47	**37**	47
	10,930	10,626	**8,758**	8,553
	85,326	79,685	**51,035**	48,465
Analysed as follows:				
Land and buildings	**80,044**	75,069	**50,838**	48,318
Investment properties	**5,282**	4,616	**197**	147
	85,326	79,685	**51,035**	48,465

The group's land and buildings and investment properties were revalued at 30 November 2012 and updated for any material changes at 31 December 2012. The basis of valuation for land and buildings and investment properties was open market value, depreciated replacement cost or surrender value as noted in note 3(o). In determining the open market value of investment properties, expected future cash flows have been discounted to their present values. The net book value of 'Land and buildings' includes HK$10,108m (2011: HK$9,384m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK$8,057m (2011: HK$13,981m). Amounts of HK$5,327m (2011: HK$9,656m) and HK$836m (2011: HK$1,041m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$5,327m (2011: HK$9,656m) is stated after deduction of non-controlling interests of HK$841m (2011: HK$1,412m) and deferred tax of HK$1,053m (2011: HK$1,872m). The amount credited to the income statement comprises the surplus of HK$834m (2011: HK$1,033m) on revaluation of investment properties, and HK$2m (2011: HK$8m) relating to the reversal of previous revaluation deficits that arose when the value of certain land and buildings fell below depreciated historical cost or surrender value.

Land and buildings and investment properties in Hong Kong, Macau and mainland China, representing 95% by value of the group's properties subject to valuation, were valued by DTZ Debenham Tie Leung Limited who has recent experience in the location and type of properties. The valuations were carried out by qualified valuers who are members of the Hong Kong Institute of Surveyors. Properties in eleven countries, which represent 5% by value of the group's properties, were valued by different independent professionally qualified valuers.

Notes on the Financial Statements (continued)

26 Property, plant and equipment *(continued)*

e *Properties leased to customers*

The group's investment properties are rented out under operating leases. The leases typically run for a period of 2-3 years and may contain an option to renew and the terms will then be renegotiated. During the current year, HK$216m (2011: HK$191m) was recognised as rental income in the income statement in respect of operating leases.

The total future minimum lease payments receivable under non-cancellable operating leases are as follows:

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**181**	163	**18**	9
After one but within five years	**98**	92	**8**	18
	279	255	**26**	27

27 Leasehold land and land use rights

The net book value of the group's interests in leasehold land and land use rights that have been accounted for as operating leases is analysed as follows:

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Medium-term leaseholds (between ten and fifty years)	**313**	330	**75**	77

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 28).

28 Other assets

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Current taxation recoverable	**1,029**	676	**823**	550
Assets held for sale	**48,280**	8,117	**44,669**	8,005
Prepayments and accrued income	**3,823**	3,135	**1,926**	1,558
Accrued interest receivable	**14,992**	14,524	**5,806**	5,774
Acceptances and endorsements	**31,965**	31,750	**21,191**	21,001
Other	**86,964**	42,113	**69,065**	20,123
	187,053	100,315	**143,480**	57,011

Assets held for sale comprise assets acquired by repossession of collateral for realisation, own properties held for sale, certain investments and assets of businesses to be sold, including the following:

On 5 December 2012, we entered into an agreement to dispose of our entire shareholding in Ping An, consisting of 613,929,279 shares, at a fixed price of HK$59 per share. The fixing of the sale price gave rise to a contingent forward sale contract, the fair value of which at year end was based on the difference between the agreed sale price and the market price for the shares, adjusted for an assessment of the probability of the transaction being completed. The adverse fair value of this contract was HK$2,694m at 31 December 2012, recorded in net trading income. The investment in Ping An is accounted for as an available-for-sale investment and carried at fair value with unrealised gains or losses recorded in other comprehensive income.

At 31 December 2012, the fair value of our investment in Ping An was HK$39,813m, included in 'Assets held for sale', with HK$31,701m accumulated unrealised gains in other comprehensive income. These unrealised gains include HK$3,591m of gains which arose after the date of the sale agreement and represent the difference between Ping An's share price at the year end and the agreed sale price. The gain from this transaction is HK$28,110m, being the proceeds of HK$36,222m based on the agreed sale price of HK$59 per share, less the original cost of HK$8,112m. The income statement impact of this transaction is a loss of HK$2,694m in 2012 and a net gain in 2013 of HK$30,804m.

On 26 October 2012, the group entered into an agreement to sell the assets and liabilities, other than the statutory deposits, of the Taiwan branch of HSBC Life (International) Limited to Allianz Taiwan Life Insurance Company Limited. The transaction is subject to regulatory approvals and is expected to complete during the first half of 2013.

On 20 December 2012, the group entered into an agreement to sell its entire 18% shareholding in Bao Viet Holdings ('Bao Viet') to Sumitomo Life Insurance Company. The transaction is subject to regulatory approvals and is expected to complete during the first quarter of 2013.

Gold bullion balances were reclassified from 'Loans and Advances to customers' to 'Other assets' during the year to reflect better the substance of the gold lending business.

Notes on the Financial Statements (continued)

29 Customer accounts

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Current accounts	**831,256**	696,435	**509,183**	410,911
Savings accounts	**2,063,565**	1,826,893	**1,433,809**	1,275,503
Other deposit accounts	**980,063**	1,041,673	**474,408**	533,658
	3,874,884	3,565,001	**2,417,400**	2,220,072

30 Trading liabilities

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit in issue	**3,470**	5,790	**796**	1,379
Other debt securities in issue	**15,479**	15,738	**15,159**	14,999
Short positions in securities	**48,116**	44,891	**26,519**	18,780
Deposits by banks	**7,982**	6,642	**7,430**	5,911
Customer accounts	**108,293**	98,370	**32,242**	37,890
	183,340	171,431	**82,146**	78,959

31 Financial liabilities designated at fair value

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Deposits by banks	**271**	302	**271**	302
Customer accounts	**1,366**	1,618	**1,366**	1,618
Debt securities in issue	**6,414**	3,990	**6,094**	3,990
Liabilities to customers under investment contracts	**36,219**	34,482	**–**	–
	44,270	40,392	**7,731**	5,910

At 31 December 2012, the carrying amount of financial liabilities designated at fair value was HK$81m higher than the contractual amount at maturity (2011: the carrying amount was HK$56m higher than the contractual amount). At 31 December 2012, the accumulated loss in fair value attributable to changes in credit risk was HK$13m (2011: the accumulated gain was HK$9m).

32 Debt securities in issue

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit	**29,066**	37,281	**9,243**	18,871
Other debt securities	**45,581**	40,191	**31,163**	27,489
	74,647	77,472	**40,406**	46,360

33 Other liabilities and provisions

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**24,705**	23,286	**15,013**	13,441
Liabilities of business held for sale	**4,811**	21,970	**3,451**	21,970
Provisions for liabilities and charges (note 35)	**2,144**	1,686	**1,266**	1,184
Acceptances and endorsements	**31,965**	31,750	**21,191**	21,001
Share based payment liability to HSBC	**2,560**	2,729	**2,068**	2,212
Other liabilities	**28,606**	26,893	**15,898**	11,777
	94,791	108,314	**58,887**	71,585

34 Liabilities under insurance contracts issued

	Gross	**Reinsurance**	**Net**
	HK$m	**HK$m**	**HK$m**
2012			
Non-life insurance liabilities			
Unearned premiums	**39**	**–**	**39**
Notified claims	**12**	**–**	**12**
Claims incurred but not reported	**26**	**–**	**26**
Other	**43**	**–**	**43**
	120	**–**	**120**
Life insurance liabilities to policyholders			
Life (non-linked)	**210,825**	**(1,389)**	**209,436**
Life (linked)	**33,948**	**(3,103)**	**30,845**
Investment contracts with discretionary participation features	**28**	**–**	**28**
	244,801	**(4,492)**	**240,309**
Total liabilities under insurance contracts	**244,921**	**(4,492)**	**240,429**
2011			
Non-life insurance liabilities			
Unearned premiums	1,674	(157)	1,517
Notified claims	984	(203)	781
Claims incurred but not reported	256	(35)	221
Other	145	–	145
	3,059	(395)	2,664
Life insurance liabilities to policyholders			
Life (non-linked)	176,238	(228)	176,010
Life (linked)	30,055	(6,666)	23,389
Investment contracts with discretionary participation features	86	–	86
	206,379	(6,894)	199,485
Total liabilities under insurance contracts	209,438	(7,289)	202,149

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

Notes on the Financial Statements (continued)

34 Liabilities under insurance contracts issued *(continued)*

a *Movement of liabilities under insurance contracts*

(i) Non-life insurance

	Gross HK$m	Reinsurance HK$m	Net HK$m
2012			
Unearned premiums			
At 1 January	**1,674**	**(157)**	**1,517**
Gross written premiums	**2,935**	**(365)**	**2,570**
Gross earned premiums	**(2,550)**	**341**	**(2,209)**
Business disposals	**(2,037)**	**181**	**(1,856)**
Foreign exchange and other movements	**17**	**–**	**17**
At 31 December	**39**	**–**	**39**
Notified and incurred but not reported claims			
At 1 January	**1,240**	**(238)**	**1,002**
– Notified claims	**984**	**(203)**	**781**
– Claims incurred but not reported	**256**	**(35)**	**221**
Claims paid in current year	**(1,135)**	**98**	**(1,037)**
Claims incurred	**1,206**	**(99)**	**1,107**
Business disposals	**(1,341)**	**246**	**(1,095)**
Foreign exchange and other movements	**68**	**(7)**	**61**
At 31 December			
– Notified claims	**12**	**–**	**12**
– Claims incurred but not reported	**26**	**–**	**26**
Total at 31 December	**38**	**–**	**38**
2011			
Unearned premiums			
At 1 January	1,495	(158)	1,337
Gross written premiums	3,318	(455)	2,863
Gross earned premiums	(3,135)	456	(2,679)
Foreign exchange and other movements	(4)	–	(4)
At 31 December	1,674	(157)	1,517
Notified and incurred but not reported claims			
At 1 January	1,303	(262)	1,041
– Notified claims	1,008	(219)	789
– Claims incurred but not reported	295	(43)	252
Claims paid in current year	(1,420)	147	(1,273)
Claims incurred	1,387	(161)	1,226
Foreign exchange and other movements	(30)	38	8
At 31 December			
– Notified claims	984	(203)	781
– Claims incurred but not reported	256	(35)	221
Total at 31 December	1,240	(238)	1,002

34 Liabilities under insurance contracts issued *(continued)*

(ii) Life insurance liabilities to policyholders

	Gross HK$m	Reinsurance HK$m	Net HK$m
2012			
Life (non-linked)			
At 1 January	**176,238**	**(228)**	**176,010**
Benefits paid	**(6,931)**	**143**	**(6,788)**
Increase in liabilities to policyholders	**42,376**	**(1,315)**	**41,061**
Foreign exchange and other movements	**(858)**	**11**	**(847)**
At 31 December	**210,825**	**(1,389)**	**209,436**
Life (linked)			
At 1 January	**30,055**	**(6,666)**	**23,389**
Benefits paid	**(7,286)**	**5,233**	**(2,053)**
Increase in liabilities to policyholders	**10,972**	**1,842**	**12,814**
Foreign exchange and other movements	**207**	**(3,512)**	**(3,305)**
At 31 December	**33,948**	**(3,103)**	**30,845**
Investment contracts with discretionary participation features			
At 1 January	**86**	**–**	**86**
Benefits paid	**(62)**	**–**	**(62)**
Increase in liabilities to policyholders	**1**	**–**	**1**
Foreign exchange and other movements	**3**	**–**	**3**
At 31 December	**28**	**–**	**28**
Total liabilities to policyholders	**244,801**	**(4,492)**	**240,309**
2011			
Life (non-linked)			
At 1 January	145,960	(161)	145,799
Benefits paid	(6,399)	178	(6,221)
Increase in liabilities to policyholders	36,997	(183)	36,814
Foreign exchange and other movements	(320)	(62)	(382)
At 31 December	176,238	(228)	176,010
Life (linked)			
At 1 January	28,920	(5,567)	23,353
Benefits paid	(1,958)	385	(1,573)
Increase in liabilities to policyholders	3,150	(802)	2,348
Foreign exchange and other movements	(57)	(682)	(739)
At 31 December	30,055	(6,666)	23,389
Investment contracts with discretionary participation features			
At 1 January	170	–	170
Benefits paid	(85)	–	(85)
Increase in liabilities to policyholders	1	–	1
Foreign exchange and other movements	–	–	–
At 31 December	86	–	86
Total liabilities to policyholders	206,379	(6,894)	199,485

Notes on the Financial Statements (continued)

35 Provisions for liabilities and charges

Provisions for liabilities and charges

	The group		The Bank	
	2012 HK$m	2011 HK$m	**2012 HK$m**	2011 HK$m
At 1 January	**1,686**	1,359	**1,184**	858
Additional provisions/increase in provisions	**1,835**	767	**1,053**	707
Provisions used	**(1,362)**	(276)	**(970)**	(243)
Amounts reversed	**(225)**	(85)	**(135)**	(54)
Exchange and other movements	**210**	(79)	**134**	(84)
At 31 December	**2,144**	1,686	**1,266**	1,184

Of which: provisions for restructuring costs

	The group		The Bank	
	2012 HK$m	2011 HK$m	**2012 HK$m**	2011 HK$m
At 1 January	**476**	83	**439**	77
Additional provisions/increase in provisions	**619**	631	**483**	580
Provisions used	**(683)**	(233)	**(556)**	(211)
Amounts reversed	**(92)**	(8)	**(78)**	(2)
Exchange and other movements	**(33)**	3	**(32)**	(5)
At 31 December	**287**	476	**256**	439

36 Subordinated liabilities

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

		2012 HK$m	2011 HK$m
The Bank			
US$1,200m	Undated floating rate primary capital notes	**9,355**	9,386
		9,355	9,386
The group			
A$42m	Floating rate subordinated notes due 2018, callable from 2013[1]	**338**	332
A$200m	Floating rate subordinated notes due 2020, callable from 2015	**1,608**	1,580
US$300m	Floating rate subordinated notes due 2017, callable from 2012[2]	**–**	2,328
RM500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017[3]	**1,267**	1,227
RM500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022[4]	**1,299**	1,261
		13,867	16,114

1 *The interest rate on the A$42m callable subordinated floating rate notes due 2018 will increase by 0.5% from March 2013.*
2 *The US$300m callable subordinated floating rate notes due 2017 were redeemed in July 2012.*
3 *The interest rate on the RM500m 4.35% callable subordinated bonds due 2022 will increase by 1% from June 2017.*
4 *The interest rate on the RM500m 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.*

37 Preference shares

Authorised

At both 31 December 2012 and 31 December 2011, the authorised preference share capital of the Bank was US$13,450.5m comprising 3,750.5m cumulative redeemable preference shares of US$1 each, 7,500m non-cumulative irredeemable preference shares of US$1 each and 2,200m cumulative irredeemable preference shares of US$1 each.

At a group level, there was an additional INR1,320m (2011: INR900m) of authorised preference share capital comprising 13.2m compulsorily convertible preference shares of INR100 each in the share capital of a subsidiary.

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Issued and fully paid				
Redeemable preference shares	**11,243**	24,862	**11,243**	24,862
Irredeemable preference shares	**68,231**	68,354	**68,080**	68,227
Share premium	**3,872**	3,880	**3,872**	3,880
	83,346	97,096	**83,195**	96,969

500,000 cumulative redeemable preference shares were issued in 1997, which have a mandatory redemption date of 2 January 2019 but may be redeemed at the Bank's option on or after 2 January 2003, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1,000 per share, comprising nominal value of US$1 per share and premium on issue of US$999 per share. 1,750m cumulative redeemable preference shares were issued in 2007, which have mandatory redemption dates between 29 March and 24 November 2017 but may be redeemed at the Bank's option on or after dates starting between 29 March and 24 November 2012, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 250m cumulative redeemable preference shares were redeemed on 29 March 2012 at US$1 per share and 1,500m cumulative redeemable preference shares were redeemed on 26 November 2012 at US$1 per share.

400m cumulative redeemable preferences shares were issued in 2008, which have a mandatory redemption date of 29 March 2023 but may be redeemed at the Bank's option on or after 29 March 2018, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 1,050m cumulative redeemable preferences shares were issued in 2009, which have a mandatory redemption date of 2 January 2024 but may be redeemed at the Bank's option on or after 2 January 2019, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 550m cumulative redeemable preference shares, issued in 2006, were redeemed at the issue price of US$1 per share on 21 December 2011. The total number of issued cumulative redeemable preference shares at 31 December 2012 was 1,450.5m (2011: 3,200.5m). No cumulative redeemable preference shares were issued during the year (2011: nil).

The non-cumulative irredeemable preference shares were issued at nominal value, and may be cancelled subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of cancellation, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of cancellation, subject to the Bank having sufficient distributable profits. The number of issued non-cumulative irredeemable preference shares at 31 December 2012 was 6,653m (2011: 6,653m). No non-cumulative irredeemable preference shares were issued during the year (2011: nil).

37 Preference shares *(continued)*

The cumulative irredeemable preference shares were issued at nominal value, and may be cancelled subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of cancellation, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of cancellation, subject to the Bank having sufficient distributable profits. The number of issued cumulative irredeemable preference shares at 31 December 2012 was 2,130m (2011: 2,130m). No cumulative irredeemable preference shares were issued during the year (2011: nil). The holders of the preference shares are entitled to one vote per share at shareholder meetings of the Bank.

8.7m compulsorily convertible preference shares ('CCPS') were issued by HSBC InvestDirect Securities (India) Limited ('HSBC InvestDirect') in 2009 at a nominal value of INR100 each. These shares may be converted into fully paid equity shares of HSBC InvestDirect at any time after one year from the date of allotment of the CCPS by written notice. The conversion shall be made at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion. The CCPS shall carry a fixed dividend of 0.001% of the face value per annum. After ten years following the allotment of the CCPS all outstanding CCPS shall be converted at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion.

During the year HSBC InvestDirect issued an additional INR450m of CCPS (2011: Nil) comprising 4.5m CCPS of INR100 each. These shares may be converted into fully paid equity shares of HSBC InvestDirect at any time after three months from the date of allotment of the CCPS by written notice. The conversion shall be made at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion. The CCPS shall carry a fixed dividend of 0.001% of the face value per annum. After six months following the allotment of the CCPS all outstanding CCPS shall be converted at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion.

HSBC InvestDirect converted 2.5m CCPS in to 3,906,250 equity shares of INR10 each at a premium of INR64 per share amounting to INR250m during 2012.

38 Share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2012 was HK$80,000m (2011: HK$50,000m) divided into 32,000m (2011: 20,000m) ordinary shares of HK$2.50 each subsequent to the increase in authorised ordinary share capital by the creation of HK$30,000m divided into 12,000m new ordinary shares of HK$2.50 each on 26 November 2012. 11,511,335,607 new ordinary shares were issued during 2012 (2011: 3,078,560,000).

Issued and fully paid

	The group and the Bank	
	2012	2011
	HK$m	HK$m
Ordinary share capital	**58,969**	30,190

	The group and the Bank	
	2012	**2012**
Ordinary shares of HK$2.50 each	**Number**	**HK$m**
At 1 January	**12,076,147,294**	**30,190**
Issued during the year	**11,511,335,607**	**28,779**
At 31 December	**23,587,482,901**	**58,969**

The holders of the ordinary shares are entitled to receive dividends as declared from time to time, rank equally with regard to the Bank's residual assets and are entitled to one vote per share at shareholder meetings of the Bank.

39 Reserves

Regulatory reserve

The Bank and its banking subsidiaries maintain a regulatory reserve to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2012, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$19,426m (31 December 2011: HK$17,108m).

Retained profits

Retained profits are the cumulative net earnings of the group that have not been paid out as dividends, but retained to be reinvested in the business.

Property revaluation reserve

The property revaluation reserve represents the difference between the current fair value of the property and its depreciated cost.

Available-for-sale investment reserve

The available-for-sale investment reserve includes the cumulative net change in the fair value of available-for-sale investments other than impairments which have been recognised in the income statement.

Cash flow hedge reserve

The cash flow hedge reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions.

Foreign exchange reserve

The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations as well as from the translation of liabilities that hedge the Bank's net investments in foreign operations.

Other reserve

The other reserve mainly comprises the share-based payment reserve account and other non-distributable reserves. The share-based payment reserve account is used to record the amount relating to share options granted to employees of the group directly by HSBC Holdings plc.

40 Maturity analysis of assets and liabilities

The following is an analysis of assets and liabilities by remaining contractual maturities at the balance sheet date:

The group

2012	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	332,279	360,798	252,996	165,126	–	–	–	–	–	1,111,199
Items in the course of collection from other banks	–	23,079	–	–	–	–	–	–	–	23,079
Placings with banks maturing after one month	–	–	120,034	30,470	26,231	7,976	–	–	–	184,711
Certificates of deposit	–	5,232	22,014	56,977	3,869	4,957	36	–	–	93,085
Hong Kong Government certificates of indebtedness	176,264	–	–	–	–	–	–	–	–	176,264
Trading assets	–	–	–	–	–	–	–	419,697	–	419,697
Financial assets designated at fair value	–	24	557	1,040	10,720	5,080	52,058	–	–	69,479
Debt securities	–	24	557	1,040	10,300	5,080	–	–	–	17,001
Equity shares	–	–	–	–	–	–	52,058	–	–	52,058
Other	–	–	–	–	420	–	–	–	–	420
Derivatives	–	–	–	–	–	–	–	394,787	4,169	398,956
Loans and advances to customers	138,085	255,694	250,361	433,467	651,084	630,123	(9,771)	–	–	2,349,043
Financial investments	–	18,871	34,623	83,593	343,059	136,023	9,873	–	–	626,042
Debt securities held to maturity	–	51	1,241	11,541	57,076	85,484	–	–	–	155,393
Debt securities available for sale	–	18,820	33,382	72,052	285,983	50,539	2,502	–	–	463,278
Equity shares available for sale	–	–	–	–	–	–	7,371	–	–	7,371
Amounts due from Group companies	109,567	38,664	9,378	2,912	6,476	2,297	–	6,710	–	176,004
Interests in associates and joint ventures	–	–	–	–	–	–	119,273	–	–	119,273
Goodwill and intangible assets	–	–	–	–	–	–	38,634	–	–	38,634
Property, plant and equipment	–	–	–	–	–	–	90,179	–	–	90,179
Deferred tax assets	–	–	–	–	–	–	2,629	–	–	2,629
Other assets	11,063	25,272	67,768	14,087	7,825	5,869	55,169	–	–	187,053
Total assets	767,258	727,634	757,731	787,672	1,049,264	792,325	358,080	821,194	4,169	6,065,327

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

The group

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2012										
Liabilities										
Hong Kong currency notes in circulation	176,264	–	–	–	–	–	–	–	–	176,264
Items in the course of transmission to other banks	–	35,525	–	–	–	–	–	–	–	35,525
Deposits by banks	128,143	100,676	8,242	1,837	4,949	288	–	–	–	244,135
Customer accounts	2,972,206	408,438	269,579	211,488	13,055	118	–	–	–	3,874,884
Trading liabilities	–	–	–	–	–	–	–	183,340	–	183,340
Financial liabilities designated at fair value	141	–	–	5,444	2,270	319	36,096	–	–	44,270
Derivatives	–	–	–	–	–	–	–	393,264	3,887	397,151
Debt securities in issue	–	5,315	3,492	20,927	40,177	4,736	–	–	–	74,647
Retirement benefit liabilities	–	–	–	–	–	–	6,725	–	–	6,725
Amounts due to Group companies	31,964	11,463	1,734	12,842	445	12,058	–	27,112	–	97,618
Other liabilities and provisions	7,739	30,060	28,394	18,029	2,766	196	7,607	–	–	94,791
Liabilities under insurance contracts issued	7,219	–	–	–	–	–	237,702	–	–	244,921
Current tax liabilities	258	249	268	3,029	38	–	–	–	–	3,842
Deferred tax liabilities	–	–	–	–	–	–	16,923	–	–	16,923
Subordinated liabilities	–	–	338	–	2,875	1,299	9,355	–	–	13,867
Preference shares	–	–	–	–	–	15,266	68,080	–	–	83,346
Total liabilities	3,323,934	591,726	312,047	273,596	66,575	34,280	382,488	603,716	3,887	5,592,249

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

The Bank

2012	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	266,622	168,717	189,400	136,448	–	–	–	–	–	761,187
Items in the course of collection from other banks	–	17,355	–	–	–	–	–	–	–	17,355
Placings with banks maturing after one month	–	–	45,276	13,570	20,881	473	–	–	–	80,200
Certificates of deposit	–	1,994	10,447	7,660	49	–	–	–	–	20,150
Hong Kong Government certificates of indebtedness	176,264	–	–	–	–	–	–	–	–	176,264
Trading assets	–	–	–	–	–	–	–	284,573	–	284,573
Financial assets designated at fair value	–	–	–	–	1,432	–	–	–	–	1,432
Debt securities	–	–	–	–	1,432	–	–	–	–	1,432
Equity shares	–	–	–	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–	–	388,298	3,541	391,839
Loans and advances to customers	86,889	132,086	118,459	230,952	374,239	345,644	(5,549)	–	–	1,282,720
Financial investments	–	10,051	11,789	40,131	170,746	24,115	3,485	–	–	260,317
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available for sale	–	10,051	11,789	40,131	170,746	24,115	972	–	–	257,804
Equity shares available for sale	–	–	–	–	–	–	2,513	–	–	2,513
Amounts due from Group companies	104,502	124,519	27,852	13,258	15,882	22,461	–	13,126	–	321,600
Investments in subsidiaries	–	–	–	–	–	–	58,819	–	–	58,819
Interests in associates and joint ventures	–	–	–	–	–	–	40,919	–	–	40,919
Goodwill and intangible assets	–	–	–	–	–	–	4,765	–	–	4,765
Property, plant and equipment	–	–	–	–	–	–	53,852	–	–	53,852
Deferred tax assets	–	–	–	–	–	–	1,333	–	–	1,333
Other assets	2,418	16,314	60,228	4,501	5,798	622	53,599	–	–	143,480
Total assets	636,695	471,036	463,451	446,520	589,027	393,315	211,223	685,997	3,541	3,900,805

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

The Bank

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2012										
Liabilities										
Hong Kong currency notes in circulation	176,264	–	–	–	–	–	–	–	–	176,264
Items in the course of transmission to other banks	–	25,766	–	–	–	–	–	–	–	25,766
Deposits by banks	104,029	89,398	5,667	1,734	3,404	288	–	–	–	204,520
Customer accounts	1,990,707	220,659	97,552	101,963	6,469	50	–	–	–	2,417,400
Trading liabilities	–	–	–	–	–	–	–	82,146	–	82,146
Financial liabilities designated at fair value	–	–	–	5,444	2,270	–	17	–	–	7,731
Derivatives	–	–	–	–	–	–	–	390,282	1,802	392,084
Debt securities in issue	–	4,855	3,347	7,537	22,763	1,904	–	–	–	40,406
Retirement benefit liabilities	–	–	–	–	–	–	3,710	–	–	3,710
Amounts due to Group companies	61,211	33,803	9,600	13,157	439	12,058	–	18,969	–	149,237
Other liabilities and provisions	3,367	20,747	20,281	7,530	2,151	97	4,714	–	–	58,887
Current tax liabilities	255	–	255	1,790	48	–	–	–	–	2,348
Deferred tax liabilities	–	–	–	–	–	–	6,194	–	–	6,194
Subordinated liabilities	–	–	–	–	–	–	9,355	–	–	9,355
Preference shares	–	–	–	–	–	15,115	68,080	–	–	83,195
Total liabilities	2,335,833	395,228	136,702	139,155	37,544	29,512	92,070	491,397	1,802	3,659,243

Notes on the Financial Statements (continued)

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

The group

2011	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	311,907	311,104	189,622	107,273	–	–	–	–	–	919,906
Items in the course of collection from other banks	–	34,546	–	–	–	–	–	–	–	34,546
Placings with banks maturing after one month	–	–	143,663	29,835	17,917	6,872	–	–	–	198,287
Certificates of deposit	–	13,008	18,542	47,138	5,559	4,399	45	–	–	88,691
Hong Kong Government certificates of indebtedness	162,524	–	–	–	–	–	–	–	–	162,524
Trading assets	–	–	–	–	–	–	–	447,968	–	447,968
Financial assets designated at fair value	–	332	1,145	1,684	10,389	3,822	40,298	–	–	57,670
Debt securities	–	332	1,145	1,684	9,749	3,822	30	–	–	16,762
Equity shares	–	–	–	–	–	–	40,268	–	–	40,268
Other	–	–	–	–	640	–	–	–	–	640
Derivatives	–	–	–	–	–	–	–	376,636	660	377,296
Loans and advances to customers	124,518	233,188	239,508	358,702	644,001	542,255	(11,301)	–	–	2,130,871
Financial investments	–	43,713	73,793	197,476	254,224	106,331	46,896	–	–	722,433
Debt securities held to maturity	–	873	2,223	5,452	53,873	72,299	–	–	–	134,720
Debt securities available for sale	–	42,840	71,570	192,024	200,351	34,032	1,719	–	–	542,536
Equity shares available for sale	–	–	–	–	–	–	45,177	–	–	45,177
Amounts due from Group companies	47,688	71,033	5,138	7,621	6,722	3,407	–	11,121	–	152,730
Interests in associates and joint ventures	–	–	–	–	–	–	91,785	–	–	91,785
Goodwill and intangible assets	–	–	–	–	–	–	34,839	–	–	34,839
Property, plant and equipment	–	–	–	–	–	–	85,294	–	–	85,294
Deferred tax assets	–	–	–	–	–	–	2,325	–	–	2,325
Other assets	12,288	20,434	15,898	22,152	4,034	8,817	16,692	–	–	100,315
Total assets	658,925	727,358	687,309	771,881	942,846	675,903	306,873	835,725	660	5,607,480

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

The group

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2011										
Liabilities										
Hong Kong currency notes in circulation	162,524	–	–	–	–	–	–	–	–	162,524
Items in the course of transmission to other banks	–	47,163	–	–	–	–	–	–	–	47,163
Deposits by banks	107,668	92,898	18,399	2,565	821	231	–	–	–	222,582
Customer accounts	2,626,096	453,716	307,705	162,600	14,761	123	–	–	–	3,565,001
Trading liabilities	–	–	–	–	–	–	–	171,431	–	171,431
Financial liabilities designated at fair value	237	–	–	–	5,796	360	33,999	–	–	40,392
Derivatives	–	–	–	–	–	–	–	379,989	3,263	383,252
Debt securities in issue	1,433	6,161	15,207	8,444	42,221	4,006	–	–	–	77,472
Retirement benefit liabilities	–	–	–	–	–	–	8,097	–	–	8,097
Amounts due to Group companies	18,783	26,259	6,737	9,154	140	9,675	–	37,675	–	108,423
Other liabilities and provisions	8,259	25,653	28,003	38,293	3,257	176	4,673	–	–	108,314
Liabilities under insurance contracts issued	953	–	–	–	–	–	208,485	–	–	209,438
Current tax liabilities	314	450	352	3,000	10	–	–	–	–	4,126
Deferred tax liabilities	–	–	–	–	–	–	14,712	–	–	14,712
Subordinated liabilities	–	–	–	2,328	1,912	2,488	9,386	–	–	16,114
Preference shares	–	–	–	–	–	28,742	68,354	–	–	97,096
Total liabilities	2,926,267	652,300	376,403	226,384	68,918	45,801	347,706	589,095	3,263	5,236,137

Notes on the Financial Statements (continued)

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

The Bank

2011	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	214,248	151,511	176,113	70,393	–	–	–	–	–	612,265
Items in the course of collection from other banks	–	29,821	–	–	–	–	–	–	–	29,821
Placings with banks maturing after one month	–	–	84,073	9,024	15,283	493	–	–	–	108,873
Certificates of deposit	–	5,987	6,467	9,943	1,584	–	6	–	–	23,987
Hong Kong Government certificates of indebtedness	162,524	–	–	–	–	–	–	–	–	162,524
Trading assets	–	–	–	–	–	–	–	317,321	–	317,321
Financial assets designated at fair value	–	–	728	172	1,383	–	–	–	–	2,283
Debt securities	–	–	728	172	1,383	–	–	–	–	2,283
Equity shares	–	–	–	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–	–	370,361	317	370,678
Loans and advances to customers	77,229	120,632	122,399	182,890	375,521	305,645	(7,714)	–	–	1,176,602
Financial investments	–	27,138	45,761	118,641	115,164	17,719	37,884	–	–	362,307
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available for sale	–	27,138	45,761	118,641	115,164	17,719	713	–	–	325,136
Equity shares available for sale	–	–	–	–	–	–	37,171	–	–	37,171
Amounts due from Group companies	63,048	96,765	20,340	19,943	13,375	20,075	–	14,455	–	248,001
Investments in subsidiaries	–	–	–	–	–	–	57,724	–	–	57,724
Interests in associates and joint ventures	–	–	–	–	–	–	28,139	–	–	28,139
Goodwill and intangible assets	–	–	–	–	–	–	4,831	–	–	4,831
Property, plant and equipment	–	–	–	–	–	–	51,876	–	–	51,876
Deferred tax assets	–	–	–	–	–	–	1,098	–	–	1,098
Other assets	2,822	11,478	9,417	14,752	3,162	428	14,952	–	–	57,011
Total assets	519,871	443,332	465,298	425,758	525,472	344,360	188,796	702,137	317	3,615,341

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

The Bank

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2011										
Liabilities										
Hong Kong currency notes in circulation	162,524	–	–	–	–	–	–	–	–	162,524
Items in the course of transmission to other banks	–	38,577	–	–	–	–	–	–	–	38,577
Deposits by banks	67,552	72,539	15,677	1,926	821	231	–	–	–	158,746
Customer accounts	1,733,694	280,554	128,032	66,418	11,311	63	–	–	–	2,220,072
Trading liabilities	–	–	–	–	–	–	–	78,959	–	78,959
Financial liabilities designated at fair value	–	–	–	–	5,796	101	13	–	–	5,910
Derivatives	–	–	–	–	–	–	–	375,712	1,453	377,165
Debt securities in issue	1,433	4,378	14,169	3,293	21,294	1,793	–	–	–	46,360
Retirement benefit liabilities	–	–	–	–	–	–	4,150	–	–	4,150
Amounts due to Group companies	32,892	53,074	13,494	9,661	422	10,105	–	33,258	–	152,906
Other liabilities and provisions	4,121	12,954	18,936	30,372	2,479	103	2,620	–	–	71,585
Current tax liabilities	307	7	275	2,155	4	–	–	–	–	2,748
Deferred tax liabilities	–	–	–	–	–	–	5,884	–	–	5,884
Subordinated liabilities	–	–	–	–	–	–	9,386	–	–	9,386
Preference shares	–	–	–	–	–	28,742	68,227	–	–	96,969
Total liabilities	2,002,523	462,083	190,583	113,825	42,127	41,138	90,280	487,929	1,453	3,431,941

Notes on the Financial Statements (continued)

41 Analysis of cash flows payable under financial liabilities by remaining contractual maturities

The group

	On demand HK$m	Due within 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	Total HK$m
At 31 December 2012						
Hong Kong currency notes in circulation	**176,264**	**–**	**–**	**–**	**–**	**176,264**
Items in the course of transmission to other banks	**–**	**35,525**	**–**	**–**	**–**	**35,525**
Deposits by banks	**128,158**	**109,010**	**1,863**	**4,993**	**326**	**244,350**
Customer accounts	**2,972,878**	**680,668**	**215,788**	**14,444**	**204**	**3,883,982**
Trading liabilities	**183,340**	**–**	**–**	**–**	**–**	**183,340**
Financial liabilities designated at fair value	**141**	**120**	**5,525**	**2,338**	**36,482**	**44,606**
Derivatives	**393,498**	**186**	**707**	**2,622**	**(13)**	**397,000**
Debt securities in issue	**–**	**9,283**	**21,817**	**43,080**	**5,624**	**79,804**
Amounts due to Group companies	**59,786**	**13,195**	**12,853**	**470**	**11,996**	**98,300**
Other financial liabilities	**7,322**	**49,764**	**15,123**	**2,422**	**120**	**74,751**
Subordinated liabilities	**–**	**475**	**400**	**4,919**	**14,275**	**20,069**
Preference shares	**–**	**950**	**1,317**	**9,068**	**104,973**	**116,308**
	3,921,387	**899,176**	**275,393**	**84,356**	**173,987**	**5,354,299**
Loan commitments	**1,184,203**	**380,861**	**26,529**	**12,554**	**–**	**1,604,147**
Financial guarantee and credit risk related guarantee contracts	**59,065**	**–**	**–**	**–**	**–**	**59,065**
	5,164,655	**1,280,037**	**301,922**	**96,910**	**173,987**	**7,017,511**
At 31 December 2011						
Hong Kong currency notes in circulation	162,524	–	–	–	–	162,524
Items in the course of transmission to other banks	–	47,163	–	–	–	47,163
Deposits by banks	107,693	111,446	2,595	882	265	222,881
Customer accounts	2,626,340	766,222	167,859	16,729	211	3,577,361
Trading liabilities	171,431	–	–	–	–	171,431
Financial liabilities designated at fair value	244	114	138	6,006	34,362	40,864
Derivatives	380,205	205	765	2,065	94	383,334
Debt securities in issue	1,433	21,703	9,260	44,378	5,197	81,971
Amounts due to Group companies	56,459	33,025	9,195	165	9,706	108,550
Other financial liabilities	7,641	48,661	37,000	2,791	118	96,211
Subordinated liabilities	–	189	2,724	3,996	16,089	22,998
Preference shares	–	874	1,413	9,148	117,189	128,624
	3,513,970	1,029,602	230,949	86,160	183,231	5,043,912
Loan commitments	1,101,283	327,017	31,249	13,080	9	1,472,638
Financial guarantee and credit risk related guarantee contracts	48,432	–	–	–	–	48,432
	4,663,685	1,356,619	262,198	99,240	183,240	6,564,982

41 Analysis of cash flows payable under financial liabilities by remaining contractual maturities *(continued)*

The Bank

	On demand HK$m	Due within 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	Total HK$m
At 31 December 2012						
Hong Kong currency notes in circulation	**176,264**	**–**	**–**	**–**	**–**	**176,264**
Items in the course of transmission to other banks	**–**	**25,766**	**–**	**–**	**–**	**25,766**
Deposits by banks	**104,037**	**95,133**	**1,757**	**3,447**	**326**	**204,700**
Customer accounts	**1,990,783**	**318,830**	**103,564**	**7,095**	**121**	**2,420,393**
Trading liabilities	**82,147**	**–**	**–**	**–**	**–**	**82,147**
Financial liabilities designated at fair value	**–**	**116**	**5,513**	**2,270**	**–**	**7,899**
Derivatives	**390,424**	**76**	**515**	**1,373**	**(54)**	**392,334**
Debt securities in issue	**–**	**8,428**	**8,022**	**24,677**	**2,194**	**43,321**
Amounts due to Group companies	**81,128**	**43,395**	**13,164**	**462**	**12,115**	**150,264**
Other financial liabilities	**3,220**	**34,111**	**6,883**	**2,007**	**66**	**46,287**
Subordinated liabilities	**–**	**82**	**246**	**1,310**	**12,577**	**14,215**
Preference shares	**–**	**950**	**1,317**	**9,068**	**104,823**	**116,158**
	2,828,003	**526,887**	**140,981**	**51,709**	**132,168**	**3,679,748**
Loan commitments	**727,721**	**289,784**	**7,467**	**9,065**	**–**	**1,034,037**
Financial guarantee and credit risk related guarantee contracts	**32,317**	**–**	**–**	**–**	**–**	**32,317**
	3,588,041	**816,671**	**148,448**	**60,774**	**132,168**	**4,746,102**
At 31 December 2011						
Hong Kong currency notes in circulation	162,524	–	–	–	–	162,524
Items in the course of transmission to other banks	–	38,577	–	–	–	38,577
Deposits by banks	67,552	88,366	1,955	882	265	159,020
Customer accounts	1,733,781	409,918	68,089	12,387	126	2,224,301
Trading liabilities	78,959	–	–	–	–	78,959
Financial liabilities designated at fair value	–	114	138	6,006	117	6,375
Derivatives	375,832	67	428	843	38	377,208
Debt securities in issue	1,433	18,661	3,559	21,706	1,974	47,333
Amounts due to Group companies	66,152	66,577	9,690	447	10,161	153,027
Other financial liabilities	3,840	28,844	29,789	2,206	74	64,753
Subordinated liabilities	–	121	207	1,313	12,604	14,245
Preference shares	–	874	1,413	9,148	117,062	128,497
	2,490,073	652,119	115,268	54,938	142,421	3,454,819
Loan commitments	675,165	234,915	11,650	8,713	6	930,449
Financial guarantee and credit risk related guarantee contracts	25,448	–	–	–	–	25,448
	3,190,686	887,034	126,918	63,651	142,427	4,410,716

The balances in the above tables will not agree directly with the balances in the consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and trading derivatives). In addition, loan 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 payable under hedging derivative liabilities are classified according to their contractual maturity. The undiscounted cash flows potentially payable under loan commitments and financial guarantee contracts are classified on the basis of the earliest date they can be called.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. In practice, however, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments and guarantee contracts expire without being drawn upon. The group's approach to managing liquidity risk is set out in note 52.

Notes on the Financial Statements (continued)

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

	2012 HK$m	2011 HK$m
Operating profit	**89,919**	76,287
Net interest income	**(82,419)**	(75,672)
Dividend income	**(522)**	(729)
Depreciation and amortisation	**5,738**	5,638
Amortisation of prepaid operating lease payments	**18**	18
Loan impairment charges and other credit risk provisions	**3,578**	3,059
Loans and advances written off net of recoveries	**(4,924)**	(4,138)
Other provisions for liabilities and charges	**1,358**	723
Provisions used	**(1,362)**	(276)
Surplus arising on property revaluation	**(2)**	(8)
Gains on investment properties	**(834)**	(1,033)
(Profit)/loss on disposal of property, plant and equipment and assets held for sale	**(30)**	3
(Profit)/loss on disposal of subsidiaries, associates and business portfolios	**(5,247)**	9
Impairment on interests in associates and joint ventures	**395**	–
Gains less losses from financial investments	**(2,634)**	(128)
Share-based payments granted cost free	**1,751**	2,274
Movement in present value of in-force business	**(4,432)**	(5,524)
Interest received	**101,158**	90,790
Interest paid	**(29,909)**	(27,458)
Operating profit before changes in working capital	**71,600**	63,835
Change in treasury bills with original term to maturity of more than three months	**(107,676)**	(56,042)
Change in placings with banks maturing after one month	**13,576**	(48,730)
Change in certificates of deposit with original term to maturity of more than three months	**(11,498)**	(15,773)
Change in trading assets	**(29,901)**	(39,833)
Change in trading liabilities	**13,212**	19,897
Change in financial assets designated as fair value	**(12,101)**	(3,066)
Change in financial liabilities designated as fair value	**3,878**	65
Change in derivative assets	**(21,677)**	(74,674)
Change in derivative liabilities	**13,958**	73,414
Change in financial investments held for backing liabilities to long-term policyholders	**(27,345)**	(19,813)
Change in loans and advances to customers	**(224,461)**	(243,760)
Change in amounts due from Group companies	**(23,275)**	(15,097)
Change in other assets	**(57,677)**	(49,408)
Change in deposits by banks	**21,553**	54,755
Change in customer accounts	**328,713**	251,757
Change in amounts due to Group companies	**(12,944)**	22,043
Change in debt securities in issue	**(2,503)**	18,189
Change in liabilities under insurance contracts issued	**38,390**	31,468
Change in other liabilities	**3,723**	47,405
Exchange adjustments	**1,804**	(49)
Cash generated from/(used in) operations	**(20,651)**	16,583

43 Analysis of cash and cash equivalents

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

	2012 HK$m	2011 HK$m
Balance at 1 January	**688,673**	618,199
Net cash inflow before the effect of foreign exchange movements	**19,859**	70,898
Effect of foreign exchange movements	**(1,346)**	(424)
Balance at 31 December	**707,186**	688,673

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

	2012 HK$m	2011 HK$m
Cash in hand and sight balances with central banks	**214,104**	110,107
Items in the course of collection from other banks	**23,079**	34,546
Placings with banks	**384,385**	481,842
Treasury bills	**114,937**	96,443
Certificates of deposit	**4,141**	11,421
Other eligible bills	**2,065**	1,477
Less: items in the course of transmission to other banks	**(35,525)**	(47,163)
	707,186	688,673

c *Disposal of subsidiaries and businesses*

	2012			
	Banking businesses HK$m	Insurance businesses HK$m	Other HK$m	Total HK$m
Assets				
Loans and advances to customers	7,638	1	84	7,723
Other assets	78	3,157	5	3,240
Interests in associates and joint ventures	–	–	1,295	1,295
Total assets excluding cash and cash equivalents	7,716	3,158	1,384	12,258
Liabilities				
Customer accounts	18,830	–	–	18,830
Other liabilities	1,787	332	41	2,160
Liabilities under insurance contracts	–	3,487	–	3,487
Total liabilities	20,617	3,819	41	24,477
Aggregate net assets/(liabilities) at date of disposal, excluding cash and cash equivalents	(12,901)	(661)	1,343	(12,219)
Gain on disposal including costs to sell	1,318	1,239	2,690	5,247
Add back: costs to sell	69	77	18	164
Selling price	(11,514)	655	4,051	(6,808)
Satisfied by				
Cash and cash equivalents received/(paid)	(11,477)	723	4,018	(6,736)
Cash and cash equivalents sold	–	(120)	–	(120)
Cash consideration received/(paid) up to 31 December 2012	(11,477)	603	4,018	(6,856)
Cash still to be received/(paid) at 31 December 2012	(37)	52	33	48
Total cash consideration	(11,514)	655	4,051	(6,808)

Notes on the Financial Statements (continued)

44 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	**225,483**	192,428	**153,546**	128,827
Other contingent liabilities	**345**	359	**295**	454
	225,828	192,787	**153,841**	129,281
Commitments				
Documentary credits and short-term trade-related transactions	**39,902**	44,524	**32,707**	33,233
Forward asset purchases and forward forward deposits placed	**3,000**	2,524	**8**	255
Undrawn formal standby facilities, credit lines and other commitments to lend	**1,561,277**	1,425,590	**1,001,322**	896,961
	1,604,179	1,472,638	**1,034,037**	930,449

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

44 Contingent liabilities and commitments *(continued)*

b *Guarantees (including financial guarantee contracts)*

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

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Guarantees in favour of third parties				
Financial guarantee contracts[1]	**34,735**	26,694	**18,896**	12,904
Standby letters of credit which are financial guarantee contracts[2]	**20,620**	19,684	**9,527**	10,294
Other direct credit substitutes[3]	**42,551**	38,211	**33,719**	32,311
Performance bonds[4]	**64,220**	54,429	**46,674**	39,289
Bid bonds[4]	**2,752**	2,169	**1,615**	1,602
Standby letters of credit related to particular transactions[4]	**20,608**	12,169	**16,007**	7,630
Other transaction-related guarantees[4]	**29,773**	31,892	**15,438**	17,678
	215,259	185,248	**141,876**	121,708
Guarantees in favour of other HSBC Group entities	**10,224**	7,180	**11,670**	7,119
	225,483	192,428	**153,546**	128,827

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

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

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

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

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

Notes on the Financial Statements (continued)

45 Assets pledged as security for liabilities and collateral accepted as security for assets

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Assets pledged to secure liabilities				
Financial assets[1] pledged to secure liabilities	**91,466**	117,963	**78,813**	74,594
Liabilities secured by financial assets	**85,789**	112,721	**73,309**	70,013
Collateral accepted as security for assets				
Fair value of the collateral permitted to sell or repledge in the absence of default[2]	**202,321**	120,319	**179,350**	88,197
Fair value of collateral actually sold or repledged	**27,245**	14,504	**11,838**	5,980

1 *Financial assets comprise treasury bills, debt securities, equities and deposits*

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.*

46 Capital commitments

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**4,231**	3,511	**2,446**	3,355
Expenditure authorised by the Directors but not contracted for	**8**	6	**3**	2
	4,239	3,517	**2,449**	3,357

Capital commitments mainly relate to the commitment to purchase premises and equipment.

47 Lease commitments

The group leases certain properties and equipment under operating leases. The leases normally run for a period of one to ten years and may include an option to renew. Lease payments are usually adjusted annually to reflect market rentals. None of the leases include contingent rentals. Future minimum lease payments under non-cancellable operating leases are as follows:

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**2,841**	3,734	**1,325**	1,414
– five years or less but over one year	**4,597**	4,603	**2,213**	2,385
– over five years	**821**	1,103	**510**	761
	8,259	9,440	**4,048**	4,560
Equipment				
Amounts payable within				
– one year or less	**92**	71	**6**	6
– five years or less but over one year	**78**	100	**10**	9
	170	171	**16**	15

48 Segmental analysis

The group’s operating segments are organised into two geographical regions, Hong Kong and Rest of Asia-Pacific. Due to the nature of the group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geographical region and by global businesses. Although the chief operating decision-maker reviews information on a number of bases, capital resources are allocated and performance assessed primarily by geographical region and the segmental analysis is presented on that basis. In addition, the economic conditions of each geographical region are highly influential in determining performance across the different types of business activity carried out in the region. Therefore, provision of segment performance on a geographical basis provides the most meaningful information with which to understand the performance of the business.

Geographical information is classified by the location of the principal operations of the subsidiary or, in the case of the Bank, by the location of the branch responsible for reporting the results or advancing the funds.

Information provided to the chief operating decision-maker of the group to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with HKFRSs. Due to the nature of the group’s structure, the analysis of profits shown below includes intra-segment items between geographical regions with the elimination shown in a separate column. Such transactions are conducted on an arm’s length basis. Shared costs are included in segments on the basis of actual recharges made.

Products and services

The group provides a comprehensive range of banking and related financial services to its customers in its two geographical regions. The products and services offered to customers are organised by global businesses:

- Retail Banking and Wealth Management offers a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Products typically include current and savings accounts, mortgages and personal loans, credit cards, debit cards, insurance, global asset management services, wealth management and local and international payment services;
- Commercial Banking product offerings include the provision of financial services, payments and cash management, international trade finance, treasury and capital markets, commercial cards, insurance, and online and direct banking offerings;
- Global Banking & Markets provides tailored financial solutions to major government, corporate and institutional clients and private investors worldwide. The client-focused business lines deliver a full range of banking capabilities including financing; advisory and transaction services; a markets business that provides services in credit, rates, foreign exchange, money markets, securities services and principal investment activities; and
- Global Private Banking provides a range of services to meet the banking, investment and wealth advisory needs of high net worth individuals.

Notes on the Financial Statements (continued)

48 Segmental analysis *(continued)*

Total assets

	2012		2011	
	HK$m	%	HK$m	%
Hong Kong	3,944,090	65.0	3,594,991	64.1
Rest of Asia-Pacific	2,639,425	43.5	2,429,228	43.3
Intra region	(518,188)	(8.5)	(416,739)	(7.4)
	6,065,327	100.0	5,607,480	100.0

Total liabilities

	2012		2011	
	HK$m	%	HK$m	%
Hong Kong	3,736,637	66.8	3,436,629	65.6
Rest of Asia-Pacific	2,373,800	42.4	2,216,247	42.3
Intra region	(518,188)	(9.2)	(416,739)	(7.9)
	5,592,249	100.0	5,236,137	100.0

Interests in associates and joint ventures

	2012		2011	
	HK$m	%	HK$m	%
Hong Kong	1,739	1.5	1,525	1.7
Rest of Asia-Pacific	117,534	98.5	90,260	98.3
	119,273	100.0	91,785	100.0

Credit commitments and contingencies (contract amounts)

	2012		2011	
	HK$m	%	HK$m	%
Hong Kong	868,161	47.4	769,088	46.2
Rest of Asia-Pacific	961,846	52.6	896,337	53.8
	1,830,007	100.0	1,665,425	100.0

Property, plant and equipment, goodwill and intangible assets acquired in the year

	2012		2011	
	HK$m	%	HK$m	%
Hong Kong	1,018	51.2	1,740	59.9
Rest of Asia-Pacific	972	48.8	1,167	40.1
	1,990	100.0	2,907	100.0

48 Segmental analysis *(continued)*

Consolidated income statement

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2012				
Interest income	**47,577**	**71,566**	**(3,632)**	**115,511**
Interest expense	**(7,422)**	**(29,295)**	**3,625**	**(33,092)**
Net interest income	**40,155**	**42,271**	**(7)**	**82,419**
Fee income	**28,770**	**19,126**	**(1,675)**	**46,221**
Fee expense	**(4,100)**	**(3,906)**	**1,675**	**(6,331)**
Net trading income	**9,892**	**9,315**	**7**	**19,214**
Net income from financial instruments designated at fair value	**3,799**	**814**	**–**	**4,613**
Gains less losses from financial investments	**2,510**	**124**	**–**	**2,634**
Dividend income	**489**	**33**	**–**	**522**
Net earned insurance premiums	**46,304**	**6,317**	**–**	**52,621**
Other operating income	**14,991**	**4,632**	**(4,286)**	**15,337**
Total operating income	**142,810**	**78,726**	**(4,286)**	**217,250**
Net insurance claims incurred and movement in liabilities to policyholders	**(49,401)**	**(5,582)**	**–**	**(54,983)**
Net operating income before loan impairment charges and other credit risk provisions	**93,409**	**73,144**	**(4,286)**	**162,267**
Loan impairment charges and other credit risk provisions	**(603)**	**(2,975)**	**–**	**(3,578)**
Net operating income	**92,806**	**70,169**	**(4,286)**	**158,689**
Operating expenses	**(36,947)**	**(36,109)**	**4,286**	**(68,770)**
Operating profit	**55,859**	**34,060**	**–**	**89,919**
Share of profit in associates and joint ventures	**640**	**18,170**	**–**	**18,810**
Profit before tax	**56,499**	**52,230**	**–**	**108,729**
Tax expense	**(8,051)**	**(9,959)**	**–**	**(18,010)**
Profit for the year	**48,448**	**42,271**	**–**	**90,719**
Profit attributable to shareholders	**43,113**	**39,895**	**–**	**83,008**
Profit attributable to non-controlling interests	**5,335**	**2,376**	**–**	**7,711**
Net operating income				
– external	**84,627**	**72,218**	**–**	**156,845**
– inter-company/inter-segment	**8,179**	**(2,049)**	**(4,286)**	**1,844**
Depreciation and amortisation included in operating expenses	**(4,187)**	**(1,551)**	**–**	**(5,738)**
Restructuring costs	**(176)**	**(990)**	**–**	**(1,166)**

48 Segmental analysis *(continued)*

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2011				
Interest income	42,309	68,706	(3,557)	107,458
Interest expense	(7,035)	(28,310)	3,559	(31,786)
Net interest income	35,274	40,396	2	75,672
Fee income	27,022	19,315	(1,171)	45,166
Fee expense	(4,162)	(3,880)	1,171	(6,871)
Net trading income	7,691	12,510	(2)	20,199
Net expense from financial instruments designated at fair value	(4,230)	(293)	–	(4,523)
Gains less losses from financial investments	310	(182)	–	128
Dividend income	723	6	–	729
Net earned insurance premiums	39,738	5,932	–	45,670
Other operating income	13,229	2,674	(4,514)	11,389
Total operating income	115,595	76,478	(4,514)	187,559
Net insurance claims incurred and movement in liabilities to policyholders	(35,778)	(4,611)	–	(40,389)
Net operating income before loan impairment charges and other credit risk provisions	79,817	71,867	(4,514)	147,170
Loan impairment charges and other credit risk provisions	(938)	(2,121)	–	(3,059)
Net operating income	78,879	69,746	(4,514)	144,111
Operating expenses	(36,106)	(36,232)	4,514	(67,824)
Operating profit	42,773	33,514	–	76,287
Share of profit in associates and joint ventures	424	14,659	–	15,083
Profit before tax	43,197	48,173	–	91,370
Tax expense	(7,703)	(9,763)	–	(17,466)
Profit for the year	35,494	38,410	–	73,904
Profit attributable to shareholders	31,165	36,426	–	67,591
Profit attributable to non-controlling interests	4,329	1,984	–	6,313
Net operating income				
– external	70,903	71,088	–	141,991
– inter-company/inter-segment	7,976	(1,342)	(4,514)	2,120
Depreciation and amortisation included in operating expenses	(4,047)	(1,591)	–	(5,638)
Restructuring costs	(520)	(344)	–	(864)

48 Segmental analysis *(continued)*

Net operating income by global business

	Retail Banking and Wealth Management HK$m	Commercial Banking HK$m	Global Banking & Markets HK$m	Global Private Banking HK$m	Other HK$m	Inter-Segment HK$m	Total HK$m
Year ended 31 December 2012							
External	**51,777**	**37,800**	**64,408**	**401**	**2,459**	**–**	**156,845**
Intercompany/intersegment	**12,636**	**638**	**(11,061)**	**336**	**5,993**	**(6,698)**	**1,844**
Year ended 31 December 2011							
External	48,615	31,821	61,508	(196)	243	–	141,991
Intercompany/intersegment	10,904	1,984	(10,824)	597	6,334	(6,875)	2,120

Information by country

	Net external operating income[1]		Non-current assets[2]	
	2012 HK$m	2011 HK$m	**2012 HK$m**	2011 HK$m
Hong Kong	**84,627**	70,903	**82,780**	91,177
Mainland China	**10,941**	11,952	**121,854**	91,687
Australia	**6,952**	7,115	**1,544**	1,629
India	**8,771**	9,684	**2,362**	2,342
Indonesia	**5,069**	4,715	**5,001**	5,349
Malaysia	**7,547**	7,232	**1,109**	1,033
Singapore	**8,876**	8,028	**1,589**	1,256
Taiwan	**3,795**	3,717	**2,487**	2,564
Vietnam	**1,424**	1,606	**1,401**	2,742
Other	**18,843**	17,039	**3,534**	5,151
Total	**156,845**	141,991	**223,661**	204,930

1 *Net external operating income is attributable to countries based on the location of the principal operations of the subsidiary or branch.*
2 *Non-current assets consist of property, plant and equipment, goodwill, other intangible assets, interests in associates and joint ventures and certain other assets expected to be recovered more than 12 months after the reporting date.*

Notes on the Financial Statements (continued)

49 Related party transactions

a *Immediate and ultimate holding company*

The group is wholly owned by HSBC Asia Holdings BV. HSBC Asia Holdings BV is in turn wholly owned by HSBC Asia Holdings (UK) Limited, which is wholly owned by HSBC Holdings BV. HSBC Holdings BV is wholly owned by HSBC Finance (Netherlands), which is wholly owned by HSBC Holdings plc (incorporated in England).

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for the benefit of the group's employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

Transactions with the immediate holding company included the redemption of preference shares and the payment of interest on preference shares. As at 31 December 2012, the Bank has issued HK$83,195m of preference shares to its immediate holding company (2011: HK$96,969m). These are classified as liabilities on the balance sheet.

Transactions with the ultimate holding company included the issuance of subordinated liabilities and the payment of interest on subordinated liabilities. As at 31 December 2012, the Bank has issued HK$11,905m of subordinated liabilities to its ultimate holding company (2011: HK$9,599m). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**2,386**	2,337	**277**	172
Other operating income	**–**	–	**243**	150
Other operating expenses	**19**	30	**1,394**	1,584

1 *Interest expense paid to the immediate holding company represents interest on preference shares. Interest expense paid to the ultimate holding company represents interest on subordinated liabilities.*

Information relating to preference shares can be found in the 'Notes on the Financial Statements' where the following are disclosed: interest expense on preference shares (note 4(b)) and preference shares issued (note 37).

Balances at 31 December

The group

	Immediate holding company		Ultimate holding company	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**191**	167
Amounts due to[2]	**84,555**	98,243	**12,285**	9,990

The Bank

	Immediate holding company		Ultimate holding company	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**151**	167
Amounts due to[2]	**84,555**	98,243	**12,122**	9,916

1 *Amounts due from the ultimate holding company are mainly IT cost recoveries.*
2 *Amounts due to the immediate holding company included preference shares of HK$83,195m (2011: HK$96,969m). Amounts due to the ultimate holding company included subordinated liabilities of HK$11,905m (2011: HK$9,599m).*

Guarantees made by the ultimate holding company to and on behalf of the group amounted to HK$326m (2011: HK$283m).

49 Related party transactions *(continued)*

b *Share option and share award schemes*

The group participates in various share option and share plans operated by HSBC whereby share options or shares of HSBC are granted to employees of the group. As disclosed in note 50, 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 share options is treated as a capital contribution and is recorded within 'Other reserves'. In respect of share awards, the group recognises a liability to the ultimate holding company over the vesting period. This liability is measured at the fair value of the shares at each reporting date, with changes since award date adjusted through the capital contribution account within 'Other reserves'. The balances of the capital contribution and the liability as at 31 December 2012 amounted to HK$2,638m and HK$2,561m respectively (2011: HK$2,915m and HK$2,729m respectively).

c *Pension funds*

At 31 December 2012, HK$12.6bn (2011: HK$12.5bn) of pension fund assets were under management by group companies. Total fees paid or payable by pension plans to group companies for providing fund management, administrative and trustee services amounted to HK$47m for the year (2011: HK$53m).

d *Subsidiaries and fellow subsidiaries*

The group entered into transactions with its fellow subsidiaries in the normal course of business, including the acceptance and placement of interbank deposits, correspondent banking transactions and off-balance sheet transactions. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The group shares the costs of certain IT projects with its fellow subsidiaries and also used certain processing services of fellow subsidiaries on a cost recovery basis. The Bank also acted as agent for the distribution of retail investment funds for fellow subsidiaries and paid professional fees for services provided by fellow subsidiaries. The commissions and fees in these transactions and services are priced on an 'arm's length' basis.

The aggregate amount of income and expenses arising from these transactions during the year and the balances of amounts due to and from the relevant parties at the year end are as follows:

Income and expenses for the year

	Fellow subsidiaries	
	2012	2011
	HK$m	HK$m
Interest income	**429**	445
Interest expense	**872**	797
Fee income	**2,582**	2,470
Fee expense	**734**	935
Other operating income	**3,022**	3,227
Other operating expenses[1]	**5,843**	5,169

1 *In 2012 payments were made of HK$920m (2011: HK$1,271m) for software costs which were capitalised as intangible assets in the balance sheet of the group.*

Notes on the Financial Statements (continued)

49 Related party transactions *(continued)*

Balances at 31 December

The group

	Fellow subsidiaries	
	2012	2011
	HK$m	HK$m
Assets		
Trading assets	**6,710**	11,120
Financial assets designated at fair value	**4,966**	5,390
Other assets	**164,136**	136,051
	175,812	152,561
Liabilities		
Trading liabilities	**27,112**	37,675
Financial liabilities designated at fair value	**2**	5
Other liabilities	**57,010**	59,605
	84,124	97,285
Guarantees	**10,224**	7,180
Commitments	**5,051**	6,689

The Bank

	Subsidiaries		Fellow subsidiaries	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Trading assets	**6,537**	3,486	**6,589**	10,970
Financial assets designated at fair value	**–**	–	**–**	–
Other assets	**157,159**	113,761	**151,163**	119,616
	163,696	117,247	**157,752**	130,586
Liabilities				
Trading liabilities	**7,764**	7,421	**11,205**	25,837
Financial liabilities designated at fair value	**–**	–	**–**	–
Other liabilities	**64,856**	54,655	**51,930**	53,803
	72,620	62,076	**63,135**	79,640
Guarantees	**2,441**	1,039	**9,229**	6,080
Commitments	**36,460**	38,484	**3,885**	3,639

Derivative balances

In addition, the group and the Bank had the following derivative asset and derivative liability balances with other HSBC Group entities:

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Derivative assets	**83,270**	85,977	**87,291**	89,781
Derivative liabilities	**96,442**	90,663	**99,688**	93,677

49 Related party transactions *(continued)*

e *Associates and joint ventures*

The group provides certain banking and financial services to associates and joint ventures, including loans, overdrafts, interest and non-interest bearing deposits and current accounts. Details of interests in associates and joint ventures are given in note 24. Transactions and balances during the year with associates and joint ventures were as follows:

The group

	2012		2011	
	Highest balance during the year HK$m	**Balance at 31 December HK$m**	Highest balance during the year HK$m	Balance at 31 December HK$m
Amounts due from associates				
– subordinated	**–**	**–**	34	33
– unsubordinated	**27,056**	**20,784**	23,418	19,183
Amounts due from joint ventures				
– subordinated	**39**	**6**	13	6
– unsubordinated	**787**	**1**	1,107	966
	27,882	**20,791**	24,572	20,188
Amounts due to associates	**6,589**	**2,020**	4,536	3,672
Amounts due to joint ventures	**1,034**	**–**	1,488	1,013
	7,623	**2,020**	6,024	4,685
Commitments	**2,529**	**349**	1,431	711

The Bank

	2012		2011	
	Highest balance during the year HK$m	**Balance at 31 December HK$m**	Highest balance during the year HK$m	Balance at 31 December HK$m
Amounts due from associates				
– unsubordinated	**5,448**	**1,297**	7,509	3,825
Amounts due from joint ventures				
– unsubordinated	**787**	**1**	881	876
	6,235	**1,298**	8,390	4,701
Amounts due to associates	**1,190**	**697**	1,065	1,065
Amounts due to joint ventures	**1,032**	**–**	1,486	1,011
	2,222	**697**	2,551	2,076
Commitments	**2,164**	**225**	1,012	351

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

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

Notes on the Financial Statements (continued)

49 Related party transactions *(continued)*

f *Key Management Personnel*

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and the group. It includes members of the Board of Directors and Executive Committee of the Bank and the Board of Directors and Group Managing Directors of HSBC Holdings plc.

The following table shows the expense in respect of compensation for Key Management Personnel of the Bank for services rendered to the Bank:

	2012 HK$m	2011 HK$m
Salaries and other short term benefits	**235**	220
Retirement benefits		
– Defined contribution plans	**11**	8
– Defined benefit plans	**1**	2
Termination benefits	**14**	–
Share-based payments	**83**	110
	344	340

Transactions, arrangements and agreements involving Key Management Personnel

Transactions, arrangements and agreements are entered into by the group with companies that may be controlled by Key Management Personnel of the group and their immediate relatives. These transactions are primarily loans and deposits:

	2012 HK$m	2011 HK$m
During the year		
Highest average assets[1]	**32,044**	43,416
Highest average liabilities[1]	**36,208**	39,548
Contribution to the group's profit before tax	**775**	818
At the year end		
Guarantees	**4,034**	3,874
Commitments	**7,698**	6,417

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

The above transactions were entered into in the ordinary course of business and on substantially the same terms, including interest rates and security, as comparable transactions with persons or companies of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

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

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.

49 Related party transactions *(continued)*

g *Loans to officers*

Officers are defined as the Board of Directors, Executive Committee members and the Secretary of the Bank and the Boards of Directors of the ultimate holding company, HSBC Holdings plc, and intermediate holding companies. Particulars of loans to officers disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

	Aggregate amount of loans outstanding at 31 December		Maximum aggregate amount of loans outstanding during the year	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
By the Bank	**80**	73	**101**	83
By subsidiaries	**10**	13	**13**	15
	90	86	**114**	98

50 Share-based payments

a *Income statement charge*

	2012	**2011**
	HK$m	**HK$m**
Restricted share awards	**1,497**	1,907
Performance share awards	**–**	17
Savings-related share option plans	**256**	350
	1,753	2,274
Equity-settled share-based payments	**1,751**	2,274
Cash-settled share-based payments	**2**	–

The above charge was computed from the fair values of the share-based payment transaction when contracted, that arose under employee share awards made in accordance with HSBC's reward structures.

b *HSBC Share Awards*

Award	**Policy**	**Purpose**
Restricted share awards (including GPSP awards)	• Vesting of awards generally subject to continued employment with HSBC • Vesting often staggered over three years. GPSP awards vest after five years • Certain shares subject to a retention requirement post-vesting. In the case of GPSP awards retention applies until cessation of employment • Awards generally not subject to performance conditions • Awards granted from 2010 onwards are subject to clawback provision prior to vesting	• Rewards employee performance, potential and retention of key employees • To defer variable pay
Performance share awards	• Vesting of awards based on three independent performance measures (relative TSR (40%), economic profit (40%) and growth in earnings per share ('EPS') (20%)) and an over-riding 'sustained improvement' judgment by the HSBC Group Remuneration Committee • Performance conditions are measured over a three year period and reviewed annually • Awards are forfeited to the extent the performance conditions have not been met	• Align interests of executives with the creation of shareholder value and recognise individual performance and potential • To reflect HSBC's relative and absolute performance over the long-term, taking account of an external measure of value creation, a measure of the extent to which the return on capital invested in HSBC is in excess of a benchmark return and a direct measure of the profits generated for shareholders
Achievement share awards	• Additional awards made throughout the three-year vesting period • Original award together with the additional share awards are released after three years of continued employment within HSBC Group • Shares awarded without corporate performance conditions	• To promote widespread interest in HSBC shares amongst employees • Rewards eligible employees for their prior year performance • High performing and/or senior and middle managers are normally eligible to receive achievement shares during their annual pay review

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

Movement on HSBC share awards

The group	Restricted share awards		Performance share awards[1]		Achievement share awards[1]	
	2012 Number (000s)	2011 Number (000s)	**2012 Number (000s)**	2011 Number (000s)	**2012 Number (000s)**	2011 Number (000s)
Outstanding at 1 January	**50,225**	38,476	**–**	283	**–**	2,911
Additions during the year	**17,450**	17,380	**–**	10	**–**	33
Released in the year	**(30,929)**	(4,674)	**–**	(61)	**–**	(2,886)
Transferred in the year	**690**	744	**–**	–	**–**	(12)
Lapsed in the year	**(1,396)**	(1,701)	**–**	(232)	**–**	(46)
Outstanding at 31 December	**36,040**	50,225	**–**	–	**–**	–
Weighted average remaining vesting period (years)	**0.75**	0.68	**–**	–	**–**	–

1 *Additions during the year comprised reinvested dividend equivalents.*

c *HSBC Share Option Plans*

Award	Policy	Purpose
Savings-related share option plans	• 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% (2011: 20%) discount to the market value immediately preceding the date of invitation (except for the one-year options granted under the US sub-plan where a 15% discount is applied)	• Eligible employees save up to £250 per month (or its equivalent in US dollars, Hong Kong dollars or Euros), with the option to use the savings to acquire shares • To align the interests of all employees with the creation of shareholder value
Executive Share Option Scheme (‘ESOS’) and Group Share Option Plan (‘GSOP’)	• Vesting of awards based on achievement of certain TSR targets • Exercisable between third and tenth anniversaries of the date of grant • Plan ceased in May 2005	• Long-term incentive plan between 2000 and 2005 during which certain HSBC employees were awarded share options • To align the interests of those higher performing employees with the creation of shareholder value

The table on page 150 shows the movement on HSBC share option plans during the year.

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a Black-Scholes model. When modelling options/awards with vesting dependent on HSBC’s Total Shareholder Return (‘TSR’) over a period, the TSR performance targets are incorporated into the model using Monte Carlo simulation. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

50 Share-based payments *(continued)*

Significant weighted average assumptions used to estimate the fair value of options granted

	1-year Savings-Related Share Option Schemes	3-year Savings-Related Share Option Schemes	5-year Savings-Related Share Option Schemes
2012			
Risk-free interest rate[1] (%)	**0.4**	**0.6**	**1.2**
Expected life[2] (years)	**1**	**3**	**5**
Expected volatility[3] (%)	**25**	**25**	**25**
Share price at grant date (£)	**5.54**	**5.54**	**5.54**
2011			
Risk-free interest rate[1] (%)	0.8	1.7	2.5
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	25	25	25
Share price at grant date (£)	6.37	6.37	6.37

1 *The risk-free rate was determined from the UK gilts yield curve. A similar yield curve was used for the International Savings-Related Share Option Plans.*
2 *The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historical observable data and is not a single input parameter but a function of various behavioural assumptions.*
3 *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.*

The expected US dollar denominated dividend yield was determined to be 5% per annum in line with consensus analyst forecasts (2011: 4.5%) which vested in subsequent years.

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

Movement on HSBC share option plan

The group

	ESOS and GSOP		Savings-related option scheme with exercise price set in GBP		Savings-related option scheme with exercise price set in HK$	
	Number (000s)	WAEP[1] £	Number (000s)	WAEP[1] £	Number (000s)	WAEP[1] HK$
2012						
Outstanding at 1 January	**15,554**	**6.95**	**14,587**	**3.93**	**43,733**	**53.06**
Granted during the year	**–**	**–**	**4,270**	**4.46**	**11,481**	**55.47**
Forfeited/expired in the year	**(4,222)**	**7.29**	**(2,864)**	**4.82**	**(4,134)**	**54.99**
Exercised during the year	**(48)**	**6.02**	**(6,876)**	**3.68**	**(20,449)**	**39.90**
Transferred in the year	**(81)**	**6.41**	**(59)**	**3.89**	**(99)**	**53.59**
Outstanding at 31 December	**11,203**	**6.83**	**9,058**	**4.08**	**30,532**	**45.54**
Exercisable at 31 December	**11,203**	**6.83**	**586**	**3.59**	**820**	**40.10**
At 31 December 2012						
Weighted average fair value of options granted during the year		**–**		**1.01**		**12.74**
Weighted average share price at the date the options were exercised		**6.08**		**5.57**		**67.85**
Weighted average remaining contractual life (years)		**1.00**		**1.40**		**1.60**
Exercise price range		**6.02 - 7.54**		**3.31 - 6.18**		**37.88 - 94.51**
2011						
Outstanding at 1 January	19,895	7.07	15,404	3.99	45,306	40.72
Granted during the year	–	–	3,551	5.10	4,857	64.99
Forfeited/expired in the year	(4,171)	7.54	(2,757)	4.88	(4,039)	53.06
Exercised during the year	(107)	6.03	(1,719)	5.47	(2,355)	60.99
Transferred in the year	(63)	7.74	108	3.71	(36)	35.98
Outstanding at 31 December	15,554	6.95	14,587	3.93	43,733	53.06
Exercisable at 31 December	15,554	6.95	317	6.01	50	91.61
At 31 December 2011						
Weighted average fair value of options granted during the year		–		1.25		15.68
Weighted average share price at the date the options were exercised		6.45		5.40		69.24
Weighted average remaining contractual life (years)		1.57		1.75		2.02
Exercise price range		6.02 - 7.96		3.31 - 6.69		37.88 - 94.51

1 *Weighted Average Exercise Price.*

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

51 Fair value of financial instruments

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

Financial instruments measured at fair value on an ongoing basis include trading assets and liabilities, instruments designated at fair value through profit or loss, derivatives, and financial instruments classified as available-for-sale (including treasury and other eligible bills, debt securities and equity securities). Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage, fee expense, and post-trade costs are included in operating expenses. The future cost of administering the over-the-counter derivative portfolio is also not included in fair value, but is expensed as incurred.

Control framework

Fair values are subject to a control framework that aims to ensure that they are either determined, or validated, by a function independent of the risk-taker.

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 used. 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 tradable 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, independent development or validation 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 within the Finance function, which reports functionally to the Group Finance Director. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

Determination of fair value of financial instruments carried at fair value

Fair values are determined according to the following hierarchy:

(a) Level 1 – Quoted market price

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

(b) 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.

(c) Level 3 – Valuation technique with significant unobservable inputs

Financial instruments valued using models where one or more significant inputs are unobservable.

51 Fair value of financial instruments *(continued)*

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 used. 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 and no block discounts are applied. 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.

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations, including interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. For collateralised counterparties and in significant major currencies, the group has adopted a discounting curve that reflects the overnight interest rate ('OIS discounting'). Prior to 2010, in line with market practice, discount curves did not reflect this overnight interest rate component but were based on a term LIBOR rate. During the period, the group applied an OIS discounting curve to an expanded range of significant currencies in line with evolving market practice. The financial effect of this change was not significant at the time of adoption.

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 derivation of fair value is more judgemental. 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 carrying amount and/or inception profit ('day 1 gain or loss') 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 level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (consensus pricing data may, for example, be used).

In certain circumstances, primarily where debt is hedged with interest rate derivatives, the group records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, if available. Where quoted prices are not available, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the group's liabilities. The change in fair value of issued debt securities attributable to the group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived by incorporating our own credit spreads in the valuation. Then, using discounted cash flow, each security is valued using a LIBOR-based discount curve. The difference in the valuations is attributable to the group's own credit spread. This methodology is applied consistently across all securities.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes.

Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

51 Fair value of financial instruments *(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 magnitude of fair value adjustments depends upon many entity-specific factors, and therefore fair value adjustments may not be comparable across the banking industry.

The group classifies fair value adjustments as either 'risk-related' or 'model-related'. The majority of these adjustments relate to Global Banking and Markets.

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.

Risk-related adjustments

(i) Bid-offer

HKAS 39 requires that portfolios are marked at bid or offer, as appropriate. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the cost that would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the actual position.

(ii) 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 rather more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

(iii) Credit risk adjustment methodology

The credit risk adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the counterparty may default and the group may not receive the full market value of the transactions.

The group calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each group legal entity and, within each entity, for each counterparty to which the entity has exposure.

The group calculates the CVA by applying the probability of default of the counterparty conditional on the non-default of the group, to the expected positive exposure of the group to the counterparty, and multiplying the result by the loss expected in the event of default. Conversely, the group calculates the DVA by applying the probability of default of the group, conditional on the non-default of the counterparty, to the expected positive exposure of the counterparty to the group, and multiplying by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

51 Fair value of financial instruments *(continued)*

From 31 December 2012, the group revised its methodologies for determining the CVA and DVA for derivatives. Historically, the probability of default used in the CVA calculation has been based on the group's internal credit rating for the counterparty, taking into account how credit ratings may deteriorate over the duration of the exposure based on historical rating transition matrices, and the probability of default used in the DVA calculation has been zero. As a result of evolving market practice, the group has decided to revise the methodology for determining the probability of default to one that uses credit default swap ('CDS') spreads where these are available and reliable for a specific counterparty, including for the group with respect to the DVA, or relevant proxies where relevant CDS spreads are not available. The derivation of a proxy has regard to the range of market practice, and considers relevant data in this context, including CDS index and rating transition data. For most products, to calculate the expected positive exposure to a counterparty, the group uses a simulation methodology to incorporate the range of potential exposures across the portfolio of transactions with the counterparty over the life of an instrument. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default assumption of 60% is generally adopted for developed market exposures, and 75% for emerging market exposures. Alternative loss given default assumptions may be adopted where both the nature of the exposure and the available data support this. The net impact of these changes was insignificant on the consolidated income statement of the Bank and the group.

For certain types of exotic derivatives, where the products are not currently supported by the simulation, or for derivative exposures in smaller trading locations, where the simulation tool is not yet available, the group adopts alternative methodologies. These may involve mapping to the results for similar products from the simulation tool or, where such a mapping approach is not appropriate, a simplified methodology is used, generally following the same principles as the simulation methodology. The calculation is applied at a trade level, with more limited recognition of credit mitigants such as netting or collateral agreements than used in the simulation methodology described previously.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises where the underlying value of the derivative prior to any credit risk adjustment is positively correlated to the probability of default of the counterparty. Where there is significant wrong-way risk, a trade specific approach is applied to reflect the wrong-way risk within the valuation.

With the exception of certain central clearing parties, all third party counterparties are included in the credit risk adjustment calculation and credit risk adjustments are not netted across group entities.

Model-related adjustments

(i) 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.

(ii) Inception profit (Day 1 profit or loss reserves)

Inception profit adjustments are adopted where the fair value estimated by a valuation model is based on one or more significant unobservable inputs. The accounting for inception profit adjustments is discussed in note 3(h). An analysis of the movement in the deferred Day 1 profit or loss reserve is provided in note 17(c).

51 Fair value of financial instruments *(continued)*

Fair value valuation bases

The approach used to calculate the fair value of each type of financial instrument is as follows:

Loans, including leveraged finance and loans held for securitisation

Loans held at fair value are valued from broker quotes and/or market data consensus providers where available. Where unavailable, fair value will be determined using valuation techniques. These techniques include discounted cash flow models, which incorporate assumptions regarding an appropriate credit spread for the loan, derived from other market instruments issued by the same or comparable entities.

Debt securities, treasury and eligible bills, and equities

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

Derivatives

Over-the-counter (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market 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 or 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.

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 above 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.

Asset-backed securities

While quoted market prices are generally used to determine the fair value of these securities, valuation models are used to substantiate the reliability of the limited market data available and to identify whether any adjustments to quoted market prices are required. For asset-backed securities, including residential mortgage-backed securities, the valuation uses an industry standard model and the assumptions relating to prepayment speeds, default rates and loss severity based on collateral type, and performance, as appropriate. The valuation's output is benchmarked for consistency against observable data for securities of a similar nature.

Private equity and strategic investments

The group's private equity and strategic investments are generally classified as available-for-sale and are not all traded in active markets. In the absence of an active market, an 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.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

Analysis of fair value determination

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

The group

	Quoted market price Level 1 HK$m	Valuation techniques using observable inputs Level 2 HK$m	Valuation techniques with significant unobservable inputs Level 3 HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2012						
Assets						
Trading assets	**219,233**	**200,232**	**232**	**419,697**	**–**	**419,697**
Financial assets designated at fair value	**46,122**	**21,808**	**1,549**	**69,479**	**–**	**69,479**
Derivatives	**5,049**	**309,812**	**825**	**315,686**	**83,270**	**398,956**
Available-for-sale investments[1]	**680,145**	**398,349**	**11,712**	**1,090,206**	**–**	**1,090,206**
Assets held for sale	**39,813**	**–**	**3,878**	**43,691**	**–**	**43,691**
Liabilities						
Trading liabilities	**62,723**	**109,526**	**11,091**	**183,340**	**–**	**183,340**
Financial liabilities designated at fair value	**–**	**44,270**	**–**	**44,270**	**–**	**44,270**
Derivatives	**6,951**	**290,099**	**3,659**	**300,709**	**96,442**	**397,151**
At 31 December 2011						
Assets						
Trading assets	306,444	140,294	1,230	447,968	–	447,968
Financial assets designated at fair value	33,552	20,637	3,481	57,670	–	57,670
Derivatives	3,146	286,765	1,408	291,319	85,977	377,296
Available-for-sale investments[1]	544,954	459,528	17,085	1,021,567	–	1,021,567
Liabilities						
Trading liabilities	53,214	103,703	14,514	171,431	–	171,431
Financial liabilities designated at fair value	–	40,392	–	40,392	–	40,392
Derivatives	6,117	285,427	1,045	292,589	90,663	383,252

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 10.*

There were no material movements between Level 1 and Level 2 during the year.

51 Fair value of financial instruments *(continued)*

The Bank

	Quoted market price Level 1 HK$m	Valuation techniques using observable inputs Level 2 HK$m	Valuation techniques with significant unobservable inputs Level 3 HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2012						
Assets						
Trading assets	**174,057**	**110,353**	**163**	**284,573**	**–**	**284,573**
Financial assets designated at fair value	**–**	**1,432**	**–**	**1,432**	**–**	**1,432**
Derivatives	**4,653**	**299,456**	**439**	**304,548**	**87,291**	**391,839**
Available-for-sale investments[1]	**528,194**	**164,010**	**7,608**	**699,812**	**–**	**699,812**
Assets held for sale	**39,813**	**–**	**3,878**	**43,691**	**–**	**43,691**
Liabilities						
Trading liabilities	**40,295**	**37,994**	**3,857**	**82,146**	**–**	**82,146**
Financial liabilities designated at fair value	**–**	**7,731**	**–**	**7,731**	**–**	**7,731**
Derivatives	**6,795**	**282,067**	**3,534**	**292,396**	**99,688**	**392,084**
At 31 December 2011						
Assets						
Trading assets	234,611	81,546	1,164	317,321	–	317,321
Financial assets designated at fair value	–	2,283	–	2,283	–	2,283
Derivatives	2,539	277,227	1,131	280,897	89,781	370,678
Available-for-sale investments[1]	453,706	219,516	12,773	685,995	–	685,995
Liabilities						
Trading liabilities	25,746	46,973	6,240	78,959	–	78,959
Financial liabilities designated at fair value	–	5,910	–	5,910	–	5,910
Derivatives	5,856	276,699	933	283,488	93,677	377,165

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 10.*

There were no material movements between Level 1 and Level 2 during the year.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

The group

	Assets					Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2012	**17,085**	**1,230**	**3,481**	**1,408**	**–**	**14,514**	**1,045**
Total gains or losses recognised in profit or loss	**(169)**	**28**	**80**	**227**	**–**	**669**	**3,080**
Total gains or losses recognised in other comprehensive income	**467**	**32**	**(3)**	**8**	**–**	**238**	**(5)**
Purchases	**419**	**104**	**760**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**–**	**2,195**	**–**
Sales	**(37)**	**(689)**	**(303)**	**–**	**–**	**–**	**–**
Deposits / settlements	**(982)**	**(355)**	**(190)**	**(24)**	**–**	**(1,756)**	**(124)**
Transfers out	**(5,071)**	**(163)**	**(2,662)**	**(811)**	**–**	**(5,083)**	**(492)**
Transfers in	**–**	**45**	**386**	**17**	**3,878**	**314**	**155**
At 31 December 2012	**11,712**	**232**	**1,549**	**825**	**3,878**	**11,091**	**3,659**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	**25**	**25**	**71**	**220**	**–**	**(42)**	**(2,893)**
At 1 January 2011	22,155	2,035	2,437	1,372	–	14,514	1,612
Total gains or losses recognised in profit or loss	(324)	(60)	52	782	–	(433)	282
Total gains or losses recognised in other comprehensive income	(1,460)	(30)	(4)	(14)	–	(71)	3
Purchases	3,544	1,070	1,459	–	–	–	–
Issues	–	–	–	–	–	2,368	–
Sales	(85)	(737)	(157)	–	–	–	–
Deposits / settlements	(4,597)	(625)	(44)	87	–	3,886	(106)
Transfers out	(2,273)	(916)	(1,276)	(930)	–	(8,009)	(768)
Transfers in	125	493	1,014	111	–	2,259	22
At 31 December 2011	17,085	1,230	3,481	1,408	–	14,514	1,045
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	(8)	5	60	58	–	(167)	(265)

1 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

51 Fair value of financial instruments *(continued)*

The Bank

	Assets					Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2012	**12,773**	**1,164**	**–**	**1,131**	**–**	**6,240**	**933**
Total gains or losses recognised in profit or loss	**–**	**25**	**–**	**(87)**	**–**	**546**	**2,942**
Total gains or losses recognised in other comprehensive income	**662**	**32**	**–**	**5**	**–**	**95**	**(5)**
Purchases	**6**	**104**	**–**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**–**	**1,970**	**–**
Sales	**–**	**(689)**	**–**	**–**	**–**	**–**	**–**
Deposits / settlements	**(954)**	**(355)**	**–**	**(31)**	**–**	**(2,117)**	**(117)**
Transfers out	**(4,879)**	**(163)**	**–**	**(596)**	**–**	**(3,018)**	**(374)**
Transfers in	**–**	**45**	**–**	**17**	**3,878**	**141**	**155**
At 31 December 2012	**7,608**	**163**	**–**	**439**	**3,878**	**3,857**	**3,534**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	**131**	**16**	**–**	**(25)**	**–**	**(47)**	**(2,788)**
At 1 January 2011	17,708	1,968	112	1,075	–	7,791	1,495
Total gains or losses recognised in profit or loss	(5)	(60)	(34)	871	–	(480)	192
Total gains or losses recognised in other comprehensive income	(1,896)	(30)	–	(15)	–	(49)	(1)
Purchases	3,001	1,070	–	–	–	–	–
Issues	–	–	–	–	–	1,952	–
Sales	–	(737)	(78)	–	–	–	–
Deposits / settlements	(3,877)	(625)	–	(25)	–	(59)	(73)
Transfers out	(2,158)	(915)	–	(884)	–	(3,169)	(702)
Transfers in	–	493	–	109	–	254	22
At 31 December 2011	12,773	1,164	–	1,131	–	6,240	933
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	214	2	–	183	–	(155)	(203)

1 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

51 Fair value of financial instruments *(continued)*

Some investments in unlisted equity shares were transferred to assets held for sale and the observability of valuations of certain debt securities resulted in these assets being transferred out of level 3 during the year. Transfers into level 3 resulted from the valuations of certain debt securities becoming unobservable during the year.

For assets designated at fair value through profit or loss, the observability of valuations of certain debt securities resulted in these assets being transferred out of level 3 during the year. Transfers into level 3 resulted from the valuations of certain debt securities becoming unobservable during the year.

For derivative assets and liabilities, an increase in the observability of equity volatilities and interest rate basis spreads during the year resulted in transfers out of level 3.

For held-for-trading liabilities, transfers into level 3 were due to a reduction in the observability of volatilities and correlations. Transfers out of level 3 resulted from an increase in the observability of volatilities and correlations.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under ‘Net trading income’.

Fair value changes on assets and liabilities designated at fair value are presented in the income statement under ‘Net income / (expense) from financial instruments designated at fair value’.

Realised gains and losses from available-for-sale securities are presented under ‘Gains less losses from financial investments’ in the income statement while unrealised gains and losses are presented in ‘Fair value changes taken to equity’ within ‘Available-for-sale investments’ in other comprehensive income.

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

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

51 Fair value of financial instruments *(continued)*

Sensitivity of fair values to reasonably possible alternative assumptions

The group

	Reflected in income statement		Reflected in other comprehensive income	
	Favourable changes HK$m	Unfavourable changes HK$m	Favourable changes HK$m	Unfavourable changes HK$m
At 31 December 2012				
Derivatives/trading assets/trading liabilities	**665**	**(642)**	**–**	**–**
Financial assets/liabilities designated at fair value	**155**	**(155)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**1,171**	**(1,171)**
At 31 December 2011				
Derivatives/trading assets/trading liabilities	353	(281)	–	–
Financial assets/liabilities designated at fair value	348	(348)	–	–
Financial investments: available-for-sale	–	–	1,663	(1,663)

The Bank

	Reflected in income statement		Reflected in other comprehensive income	
	Favourable changes HK$m	Unfavourable changes HK$m	Favourable changes HK$m	Unfavourable Changes HK$m
At 31 December 2012				
Derivatives/trading assets/trading liabilities	**587**	**(563)**	**–**	**–**
Financial assets/liabilities designated at fair value	**–**	**–**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**761**	**(761)**
At 31 December 2011				
Derivatives/trading assets/trading liabilities	223	(153)	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Financial investments: available-for-sale	–	–	1,232	(1,232)

Changes in fair value recorded in the income statement

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

- the table details the total change in fair value of these instruments; it does not isolate that component of the change that is attributable to the non-observable component; and
- instruments valued with significant non-observable inputs are frequently dynamically hedged with instruments valued using observable inputs; the table does not include any changes in fair value of these hedges.

	The group		The Bank	
	2012 HK$m	2011 HK$m	**2012 HK$m**	2011 HK$m
At 31 December				
Derivatives/trading assets/trading liabilities	**(2,690)**	(369)	**(2,844)**	(173)
Financial assets/liabilities designated at fair value	**71**	60	**–**	–

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

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 in the balance sheet. For all other instruments the fair value is equal to the carrying value:

The group

	31 December 2012		31 December 2011	
	Carrying value HK$m	**Fair value HK$m**	Carrying value HK$m	Fair value HK$m
Assets				
Placings with banks	**546,908**	**548,115**	654,581	654,756
Loans and advances to customers	**2,349,043**	**2,335,254**	2,130,871	2,101,243
Debt securities	**163,819**	**176,172**	143,062	151,363
Liabilities				
Deposits by banks	**244,135**	**244,136**	222,582	222,697
Customer accounts	**3,874,884**	**3,875,259**	3,565,001	3,565,036
Debt securities in issue	**74,647**	**74,854**	77,472	77,330
Subordinated liabilities	**13,867**	**12,497**	16,114	14,157
Preference shares	**83,346**	**73,762**	97,096	86,932

The Bank

	31 December 2012		31 December 2011	
	Carrying value HK$m	**Fair value HK$m**	Carrying value HK$m	Fair value HK$m
Assets				
Placings with banks	**246,104**	**246,718**	341,527	341,970
Loans and advances to customers	**1,282,720**	**1,274,154**	1,176,602	1,159,635
Liabilities				
Deposits by banks	**204,520**	**204,520**	158,746	158,743
Customer accounts	**2,417,400**	**2,417,576**	2,220,072	2,220,031
Debt securities in issue	**40,406**	**40,552**	46,360	46,245
Subordinated liabilities	**9,355**	**7,894**	9,386	7,354
Preference shares	**83,195**	**73,611**	96,969	86,805

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

Assets
Cash and balances at central banks
Hong Kong Government certificates of indebtedness
Items in the course of collection from other banks
Endorsements and acceptances
Short-term receivables within ‘Other assets’
Accrued income

Liabilities
Items in the course of transmission to other banks
Hong Kong currency notes in circulation
Endorsements and acceptances
Short-term payables within ‘Other liabilities’
Accruals
Investment contracts with discretionary participation features within ‘Liabilities under insurance contracts’

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

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

51 Fair value of financial instruments *(continued)*

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

Loans and advances to customers

The fair value of loans and advances to customers is based on observable market transactions where available. In the absence of observable market transactions, fair value is estimated using discounted cash flow models.

Performing loans are grouped, as far as possible, in to homogenous pools segregated by maturity and interest rates and the contractual cash flows are generally discounted using the group's estimate of the discount rate that market participants would use in valuing instruments with similar maturity, re-pricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

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 earning streams of equivalent quoted securities.

Deposits and customer accounts

For the purpose of estimating fair value, deposits 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 deposits repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

Debt securities in issue and subordinated liabilities

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

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

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

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

Notes on the Financial Statements (continued)

52 Risk management

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

- credit risk;
- liquidity and funding risk;
- market risk (including foreign exchange, interest rate and equity price risks);
- operational risk;
- insurance risk; and
- capital management

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

a *Credit risk*

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

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

52 **Risk management** *(continued)*

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

RMC has the responsibility for risk approval authorities and approving definitive risk policies and controls. It monitors risk inherent to the financial services business, receives reports, determines action to be taken and reviews the efficacy of the risk management framework.

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

The Risk Committee also has responsibility for oversight and advice to the Board on risk matters. The key responsibilities of the Risk Committee in this regard include preparing advice to the Board on the overall risk appetite tolerance and strategy within the group and seeking such assurance as it may deem appropriate that account has been taken of the current and prospective macroeconomic and financial environment. The Risk Committee is also responsible for the periodic review of the effectiveness of the internal control and risk management frameworks and advising the Board on all high level risk matters. The Risk Committee approves the appointment and removal of the group Chief Risk Officer.

(i) Credit exposure

Maximum exposure to credit risk

Our credit exposure is spread across a broad range of asset classes, including derivatives, trading assets, loans and advances to customers, loans and advances to banks and financial investments.

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements (unless such credit enhancements meet accounting offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

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

The group

	2012 HK$m	2011 HK$m
Cash and short-term funds	**1,111,199**	919,906
Items in the course of collection from other banks	**23,079**	34,546
Placings with banks maturing after one month	**184,711**	198,287
Certificates of deposit	**93,085**	88,691
Hong Kong Government certificates of indebtedness	**176,264**	162,524
Trading assets	**389,296**	432,908
Debt securities	**176,757**	168,849
Treasury bills and other eligible bills	**155,464**	230,959
Other	**57,075**	33,100
Financial assets designated at fair value	**17,421**	17,402
Debt securities	**17,001**	16,762
Other	**420**	640
Derivatives	**398,956**	377,296
Loans and advances to customers	**2,349,043**	2,130,871
Financial investments: Debt securities	**618,671**	677,256
Amounts due from Group companies	**176,004**	152,730
Other assets	**80,105**	77,521
Acceptances and endorsements	**31,965**	31,750
Other	**48,140**	45,771
Financial guarantees and other credit-related contingent liabilities	**59,065**	48,432
Loan commitments and other credit-related commitments	**1,820,719**	1,683,589
At 31 December	**7,497,618**	7,001,959

The Bank

	2012 HK$m	2011 HK$m
Cash and short-term funds	**761,187**	612,265
Items in the course of collection from other banks	**17,355**	29,821
Placings with banks maturing after one month	**80,200**	108,873
Certificates of deposit	**20,150**	23,987
Hong Kong Government certificates of indebtedness	**176,264**	162,524
Trading assets	**254,323**	302,343
Debt securities	**125,372**	120,575
Treasury bills and other eligible bills	**116,214**	160,911
Other	**12,737**	20,857
Financial assets designated at fair value: debt securities	**1,432**	2,283
Derivatives	**391,839**	370,678
Loans and advances to customers	**1,282,720**	1,176,602
Financial investments: Debt securities	**257,804**	325,136
Amounts due from group companies	**321,600**	248,001
Other assets	**45,231**	43,059
Acceptances and endorsements	**21,191**	21,001
Other	**24,040**	22,058
Financial guarantees and other credit-related contingent liabilities	**32,317**	25,448
Loan commitments and other credit-related commitments	**1,167,024**	1,067,049
At 31 December	**4,809,446**	4,498,069

52 Risk management *(continued)*

(ii) Credit quality of financial instruments

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

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

Credit quality classification

Quality Classification	Debt securities/ other bills	Wholesale lending and derivatives		Retail lending	
	External rating	Internal credit rating	Probability of default	Internal credit rating [1]	Expected loss %
Strong	A– and above	CRR 1 to CRR 2	0 – 0.169	EL 1 to EL 2	0 – 0.999
Medium	B+ to BBB+, and unrated	CRR 3 to CRR 5	0.170 – 4.914	EL 3 to EL 5	1.000 – 19.999
Sub-standard	B and below	CRR 6 to CRR 8	4.915 – 99.999	EL 6 to EL 8	20.000 – 99.999
Impaired	Impaired	CRR 9 to CRR 10	100	EL 9 to EL 10	100+ or defaulted [2]

1 *We observe the convention that, in addition to those classified as EL9 to EL10, retail accounts classified EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired. (See note 52(v))*

2 *The EL percentage is derived through a combination of PD and LGD, and may exceed 100% in circumstances where the LGD is above 100%, reflecting the cost of recoveries.*

Quality classification definitions

- Strong: Exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.

- Medium: Exposures require closer monitoring, with low to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal following the adoption of recovery processes.

- Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.

- Impaired: Exposures have been assessed, individually or collectively, as impaired. The group observes the convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ('Expected Loss') grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

  The group's policy in respect of impairment on loans and advances and debt securities is set out in notes 3(d) and 3(g) on the Financial Statements. Analysis of impairment allowances as at 31 December 2012 and the movement of such allowances during the year are disclosed in note 19.

52 Risk management *(continued)*

Granular risk rating scales

The CRR ('Customer Risk Rating') 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 Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures.

The basis of reporting reflects risk rating systems under the HSBC Group's Basel II programme and to extend the range of financial instruments covered in the presentation of portfolio quality.

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

(iii) Collateral and other credit enhancements

Loans and advances

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 other lending a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default the bank may use the collateral as a source of repayment.

Depending on its form, collateral can have a significant financial effect in mitigating our exposure to credit risk. The tables below provide a quantification of the value of fixed charges we hold over a borrower's specific asset (or assets) where we have a history of enforcing, and are able to enforce, the collateral in satisfying a debt in the event of the borrower failing to meet its contractual obligations, and where the collateral is cash or can be realised by sale in an established market. The collateral valuation in the tables below exclude any adjustments for obtaining and selling the collateral.

We may also manage our risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised may benefit from such credit mitigants.

52 Risk management *(continued)*

Personal lending

Residential mortgages including loan commitments by level of collateral

	2012 HK$m	2011 HK$m
Not collateralised	**79**	1,290
Fully collateralised	**747,689**	659,976
– Less than 25% LTV	**96,626**	60,167
– 25% to 50% LTV	**329,650**	230,027
– 51% to 75% LTV	**249,448**	278,216
– 76% to 90% LTV	**62,920**	81,597
– 91% to 100% LTV	**9,045**	9,969
Partially collateralised		
– Greater than 100% LTV	**2,929**	4,156
– Collateral value	**2,513**	3,912
Total residential mortgages	**750,697**	665,422

The above table shows residential mortgage lending including off-balance sheet loan commitments by level of collateral. The collateral included in the table above consists of fixed first charges on real estate.

The loan-to-value ('LTV') ratio 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 divided by the value of collateral. The methodologies for obtaining residential property collateral values vary throughout the group, but are typically determined through a combination of professional appraisals, house price indices or statistical analysis. Valuations must be updated on a regular basis and, as a minimum, at intervals of every three years. Valuations are conducted more frequently when market conditions or portfolio performance are subject to significant change or where a loan is identified and assessed as impaired.

Other personal lending

Other personal lending consists primarily of personal loans, overdrafts and credit cards, all of which are generally unsecured.

52 Risk management *(continued)*

Corporate, commercial and financial (non-bank) lending

Collateral held is analysed below separately for commercial real estate and for other corporate, commercial and financial (non-bank) lending. This reflects the difference in collateral held on the portfolios. In each case, the analysis includes off-balance sheet loan commitments, primarily undrawn credit lines.

Commercial real estate loans and advances including loan commitments by level of collateral

	2012 HK$m	2011 HK$m
Rated CRR/EL 1 to 7	**314,079**	280,706
Not collateralised	**111,895**	120,602
Fully collateralised	**181,832**	144,975
Partially collateralised (A)	**20,352**	15,129
– collateral value on A	**12,735**	6,770
Rated CRR/EL 8 to 10	**878**	616
Not collateralised	**–**	95
Fully collateralised	**486**	193
– Less than 25% LTV	**12**	–
– 25% to 50% LTV	**437**	14
– 51% to 75% LTV	**17**	9
– 76% to 90% LTV	**9**	14
– 91% to 100% LTV	**11**	156
Partially collateralised (B)	**392**	328
– collateral value on B	**115**	203
Total commercial real estate loans and advances	**314,957**	281,322

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).

52 Risk management *(continued)*

Other corporate, commercial and financial (non-bank) loans and advances rated CRR/EL 8 to 10 only including loan commitments by level of collateral.

	2012 HK$m	2011 HK$m
Not collateralised	**6,447**	8,882
Fully collateralised	**1,784**	1,634
– Less than 25% LTV	**113**	107
– 25% to 50% LTV	**515**	588
– 51% to 75% LTV	**547**	334
– 76% to 90% LTV	**278**	251
– 91% to 100% LTV	**331**	354
Partially collateralised (A)	**2,591**	1,985
– collateral value on A	**1,011**	1,015
Total	**10,822**	12,501

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. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

Loans and advances to banks

Loans and advances to banks including loan commitments by level of collateral

	2012 HK$m	2011 HK$m
Not collateralised	**492,106**	615,783
Fully collateralised	**61,702**	64,411
Partially collateralised (A)	**20,661**	3,847
– collateral value on A	**20,054**	1,996
Total loans and advances to banks	**574,469**	684,041

The collateral used in the assessment of the above relates primarily to cash and marketable securities. Loans and advances to banks are typically unsecured. Certain products such as reverse repurchase agreements and stock borrowing are effectively collateralised and have been included in the above as fully or partially collateralised.

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

Derivatives

The International Swaps and Derivatives Association ('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 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 another pre-agreed termination event occurs. It is common, and our 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 institution clients.

Other credit risk exposures

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 asset-backed securities ('ABS's) and similar instruments, which are supported by underlying pools of financial assets. Credit risk associated with ABSs is reduced through the purchase of credit default swap ('CDS') protection.

Trading assets include loans and advances held with trading intent, the majority of which consist of reverse repos and stock 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 45 '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 guarantee is called upon or a loan commitment is drawn and subsequently defaults. Further information about these arrangements is provided in Note 44 'Contingent liabilities and commitments'.

The carrying amount of assets obtained by taking possession of collateral held as security, or calling upon other credit enhancements, is as follows:

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**115**	103	**21**	35
Commercial and industrial properties	**26**	6	**23**	–
Other assets	**3**	3	**–**	–
	144	112	**44**	35

Repossessed assets are made available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. 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 own business use.

52 Risk management *(continued)*

(iv) Distribution of financial instruments by credit quality

The group

31 December 2012	Neither past due nor impaired: Strong HK$m	Medium[1] HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	**21,044**	**2,035**	**–**	**–**	**–**	**–**	**23,079**
Trading assets	**288,274**	**99,986**	**1,036**	**–**	**–**	**–**	**389,296**
– treasury and other eligible bills	**131,405**	**23,926**	**133**	**–**	**–**	**–**	**155,464**
– debt securities	**131,588**	**44,312**	**857**	**–**	**–**	**–**	**176,757**
– loans and advances to banks	**21,001**	**1,190**	**–**	**–**	**–**	**–**	**22,191**
– loans and advances to customers	**4,280**	**30,558**	**46**	**–**	**–**	**–**	**34,884**
Financial assets designated at fair value	**14,705**	**2,716**	**–**	**–**	**–**	**–**	**17,421**
– debt securities	**14,705**	**2,296**	**–**	**–**	**–**	**–**	**17,001**
– loans and advances to customers	**–**	**420**	**–**	**–**	**–**	**–**	**420**
Derivatives	**334,877**	**63,793**	**286**	**–**	**–**	**–**	**398,956**
Loans and advances held at amortised cost	**1,792,378**	**1,040,803**	**26,324**	**33,203**	**13,014**	**(9,771)**	**2,895,951**
– loans and advances to banks	**472,123**	**72,026**	**2,682**	**77**	**–**	**–**	**546,908**
– loans and advances to customers	**1,320,255**	**968,777**	**23,642**	**33,126**	**13,014**	**(9,771)**	**2,349,043**
Financial investments	**1,133,090**	**110,743**	**2,816**	**–**	**5**	**–**	**1,246,654**
– treasury and other eligible bills	**512,674**	**21,661**	**563**	**–**	**–**	**–**	**534,898**
– debt securities	**620,416**	**89,082**	**2,253**	**–**	**5**	**–**	**711,756**
Other assets	**31,901**	**47,101**	**774**	**228**	**101**	**–**	**80,105**
– endorsements and acceptances	**8,624**	**22,759**	**580**	**2**	**–**	**–**	**31,965**
– other	**23,277**	**24,342**	**194**	**226**	**101**	**–**	**48,140**
Total	**3,616,269**	**1,367,177**	**31,236**	**33,431**	**13,120**	**(9,771)**	**5,051,462**

1 *Includes HK$108,872m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

31 December 2011	Neither past due nor impaired Strong HK$m	Medium[1] HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	32,852	1,690	4	–	–	–	34,546
Trading assets	371,013	61,562	333	–	–	–	432,908
– treasury and other eligible bills	224,302	6,657	–	–	–	–	230,959
– debt securities	123,177	45,596	76	–	–	–	168,849
– loans and advances to banks	22,413	3,491	257	–	–	–	26,161
– loans and advances to customers	1,121	5,818	–	–	–	–	6,939
Financial assets designated at fair value	14,701	2,701	–	–	–	–	17,402
– debt securities	14,061	2,701	–	–	–	–	16,762
– loans and advances to customers	640	–	–	–	–	–	640
Derivatives	320,122	56,721	453	–	–	–	377,296
Loans and advances held at amortised cost	1,778,778	954,195	23,329	26,600	13,851	(11,301)	2,785,452
– loans and advances to banks	581,800	71,227	1,252	302	–	–	654,581
– loans and advances to customers	1,196,978	882,968	22,077	26,298	13,851	(11,301)	2,130,871
Financial investments	1,018,523	99,824	1,048	–	57	–	1,119,452
– treasury and other eligible bills	329,458	24,047	–	–	–	–	353,505
– debt securities[2]	689,065	75,777	1,048	–	57	–	765,947
Other assets	28,910	46,338	1,635	545	93	–	77,521
– endorsements and acceptances	6,549	24,320	876	–	5	–	31,750
– other	22,361	22,018	759	545	88	–	45,771
Total	3,564,899	1,223,031	26,802	27,145	14,001	(11,301)	4,844,577

1 *Includes HK$91,657m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*
2 *Includes HK$16m of impaired debt securities overdue more than 1 year.*

52 Risk management *(continued)*

The Bank

31 December 2012	Neither past due nor impaired Strong HK$m	Medium[1] HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	15,546	1,809	–	–	–	–	17,355
Trading assets	190,792	63,255	276	–	–	–	254,323
– treasury and other eligible bills	92,288	23,926	–	–	–	–	116,214
– debt securities	91,255	33,887	230	–	–	–	125,372
– loans and advances to banks	3,513	501	–	–	–	–	4,014
– loans and advances to customers	3,736	4,941	46	–	–	–	8,723
Financial assets designated at fair value: debt securities	576	856	–	–	–	–	1,432
Derivatives	330,679	61,023	137	–	–	–	391,839
Loans and advances held at amortised cost	931,321	565,029	15,224	16,251	6,548	(5,549)	1,528,824
– loans and advances to banks	208,565	37,414	49	76	–	–	246,104
– loans and advances to customers	722,756	527,615	15,175	16,175	6,548	(5,549)	1,282,720
Financial investments	613,227	83,922	145	–	5	–	697,299
– treasury and other eligible bills	398,367	20,978	–	–	–	–	419,345
– debt securities	214,860	62,944	145	–	5	–	277,954
Other assets	18,370	26,278	509	62	12	–	45,231
– endorsements and acceptances	6,482	14,350	359	–	–	–	21,191
– other	11,888	11,928	150	62	12	–	24,040
Total	2,100,511	802,172	16,291	16,313	6,565	(5,549)	2,936,303

1 *Includes HK$94,465m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

31 December 2011	Neither past due nor impaired: Strong HK$m	Neither past due nor impaired: Medium[1] HK$m	Neither past due nor impaired: Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	28,334	1,483	4	–	–	–	29,821
Trading assets	254,395	47,615	333	–	–	–	302,343
– treasury and other eligible bills	154,316	6,595	–	–	–	–	160,911
– debt securities	84,222	36,277	76	–	–	–	120,575
– loans and advances to banks	14,742	1,531	257	–	–	–	16,530
– loans and advances to customers	1,115	3,212	–	–	–	–	4,327
Financial assets designated at fair value: debt securities	587	1,696	–	–	–	–	2,283
Derivatives	317,049	53,294	335	–	–	–	370,678
Loans and advances held at amortised cost	972,734	519,868	12,504	11,786	8,951	(7,714)	1,518,129
– loans and advances to banks	303,108	37,739	386	294	–	–	341,527
– loans and advances to customers	669,626	482,129	12,118	11,492	8,951	(7,714)	1,176,602
Financial investments	571,375	76,344	1,048	–	57	–	648,824
– treasury and other eligible bills	278,105	21,596	–	–	–	–	299,701
– debt securities	293,270	54,748	1,048	–	57	–	349,123
Other assets	11,255	30,556	1,080	82	86	–	43,059
– endorsements and acceptances	3,949	16,665	382	–	5	–	21,001
– other	7,306	13,891	698	82	81	–	22,058
Total	2,155,729	730,856	15,304	11,868	9,094	(7,714)	2,915,137

1 *Includes HK$81,436m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

52 Risk management *(continued)*

(v) Ageing analysis of past due but not yet impaired financial instruments

The amounts in the following table reflect exposures designated as past due but not impaired. Examples of exposures designated as past due but not impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment and 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.

The group

	Up to 29 days HK$m	30-59 days HK$m	60-89 days HK$m	90-180 days HK$m	Over 180 days HK$m	Total HK$m
31 December 2012						
Loans and advances held at amortised cost	**26,876**	**4,874**	**1,353**	**81**	**19**	**33,203**
– loans and advances to banks	**77**	**–**	**–**	**–**	**–**	**77**
– loans and advances to customers[1]	**26,799**	**4,874**	**1,353**	**81**	**19**	**33,126**
Financial investments	**–**	**–**	**–**	**–**	**–**	**–**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**–**	**–**	**–**	**–**	**–**	**–**
Other assets	**96**	**37**	**38**	**31**	**26**	**228**
	26,972	**4,911**	**1,391**	**112**	**45**	**33,431**
31 December 2011						
Loans and advances held at amortised cost	21,616	3,685	1,113	143	43	26,600
– loans and advances to banks	302	–	–	–	–	302
– loans and advances to customers[1]	21,314	3,685	1,113	143	43	26,298
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	138	143	71	66	127	545
	21,754	3,828	1,184	209	170	27,145

The Bank

	Up to 29 days HK$m	30-59 days HK$m	60-89 days HK$m	90-180 days HK$m	Over 180 days HK$m	Total HK$m
31 December 2012						
Loans and advances held at amortised cost	**13,187**	**2,518**	**509**	**21**	**16**	**16,251**
– loans and advances to banks	**76**	**–**	**–**	**–**	**–**	**76**
– loans and advances to customers[1]	**13,111**	**2,518**	**509**	**21**	**16**	**16,175**
Financial investments	**–**	**–**	**–**	**–**	**–**	**–**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**–**	**–**	**–**	**–**	**–**	**–**
Other assets	**23**	**9**	**3**	**10**	**17**	**62**
	13,210	**2,527**	**512**	**31**	**33**	**16,313**
31 December 2011						
Loans and advances held at amortised cost	9,628	1,700	410	31	17	11,786
– loans and advances to banks	294	–	–	–	–	294
– loans and advances to customers[1]	9,334	1,700	410	31	17	11,492
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	28	16	13	14	11	82
	9,656	1,716	423	45	28	11,868

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

52 Risk management *(continued)*

(vi) Impaired loans and advances

The group's policy for recognising and measuring impairment allowances on both individually assessed loans and advances and those which are collectively assessed on a portfolio basis is described in note 3(d).

Analyses of impairment allowances at 31 December 2012, and the movement of such allowances during the year, are disclosed in note 19.

b *Liquidity and funding risk*

The management of liquidity and funding is primarily undertaken locally (by country) in our operating entities, in compliance with the Group's liquidity and funding risk framework (the 'framework') and with practices and limits set by the Group Management Board ('GMB') through the Risk Management Meeting and approved by the Board. These limits vary according to the depth and liquidity of the markets in which the entities operate. Our general policy is that each defined operating entity should be self-sufficient in funding its own activities. Where transactions exist between operating entities, they are reflected symmetrically in both entities.

As part of our Asset, Liability and Capital Management ('ALCM') structure, we have established Asset and Liability Management Committees ('ALCOs') at Group level, in the regions and in operating entities. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

The primary responsibility for managing liquidity and funding within the Group's framework and risk appetite resides with the local operating entity ALCO. Our most significant operating entities are overseen by regional ALCOs, Group ALCO and the Risk Management Meeting. The remaining smaller operating entities are overseen by regional ALCOs, with appropriate escalation of significant issues to Group ALCO and the Risk Management Meeting.

Operating entities are predominately defined on a country basis to reflect our local management of liquidity and funding. Typically, an operating entity will be defined as a single legal entity. However, to take account of the situation where operations in a country are booked across multiple subsidiaries or branches:

- an operating entity may be defined as a wider sub-consolidated group of legal entities if they are incorporated in the same country, liquidity and funding are freely fungible between the entities and permitted by local regulation, and the definition reflects how liquidity and funding are managed locally; or
- an operating entity may be defined more narrowly as a principal office (branch) of a wider legal entity operating in multiple countries, reflecting the local country management of liquidity and funding.

Compliance with liquidity and funding requirements is monitored by local ALCO which report to the group ALCM on a regular basis. This process includes:

- maintaining compliance with relevant regulatory requirements of the operating 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;
- maintaining debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

52 Risk management *(continued)*

Primary sources of funding

Customer deposits in the form of current accounts and savings deposits payable on demand or at short notice form a significant part of our funding, and we place considerable importance on maintaining their stability. For deposits, stability depends upon preserving depositor confidence in our capital strength and liquidity, and on competitive and transparent pricing. Professional markets are accessed for the purposes of providing additional funding, maintaining a presence in local money markets and optimising asset and liability maturities.

The management of funding and liquidity risk

Inherent liquidity risk categorisation

We place our operating entities into one of three categories (low, medium and high) to reflect our assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the host country and factors specific to the 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 an 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 our risk appetite and is used to determine the prescribed stress scenario that we require our 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 inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer and the size and pricing of the deposit. No deposit is considered to be core in its entirety unless it is contractually collateralising a loan. 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 are:

- price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;
- size: depositors with total funds above certain monetary thresholds are excluded. 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 to which the deposit is associated. The proportion of any customer deposit that can be considered core under this filter is between 35% and 90%.

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

Advances to core funding ratio

The group emphasises the importance of core customer deposits as a source of funds to finance lending to customers, and mitigate against reliance on short-term professional funding. Limits are placed on operating entities to restrict their 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 Risk Management Meeting for the most significant operating entities, and by regional ALCOs for smaller operating entities, and are monitored by ALCM teams. 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.

52 Risk management *(continued)*

Stressed coverage ratios

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 out to three months under the combined market-wide and HSBC-specific stress scenario defined by the inherent risk categorisation of the operating entity concerned.

Compliance with liquidity and funding requirements is monitored by local ALCOs which report to the group ALCM on a regular basis.

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

	Advances to core funding ratio		Stressed one month coverage ratio		Stressed three month coverage ratio	
	2012	2011	**2012**	2011	**2012**	2011
	%	%	**%**	%	**%**	%
Year-end	**73.1**	75.0	**129.5**	122.9	**126.1**	118.5
Maximum	**75.0**	78.9	**133.6**	144.6	**126.2**	125.9
Minimum	**71.4**	70.3	**122.9**	116.4	**118.5**	109.5
Average	**73.1**	75.9	**129.0**	124.0	**123.4**	116.2

Liquidity behaviouralisation

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 is reviewed and approved by local ALCOs in compliance with policies set by the Risk Management Meeting. Our approach to liquidity risk management will often mean a different approach is applied to assets and liabilities. For example, management may assume a shorter life for liabilities and a longer-term funding requirement for assets.

Contingent liquidity risk

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.

Liquidity ratio under the Hong Kong Banking Ordinance

The Hong Kong Banking Ordinance also requires banks operating in Hong Kong to maintain a minimum liquidity ratio. The requirement applies separately to the Hong Kong branches of the Bank and to those subsidiaries which are Authorised Institutions under the Banking Ordinance in Hong Kong.

52 Risk management *(continued)*

c *Market risk*

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

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

The management of market risk is principally undertaken in Global Markets through risk limits approved by the group's Executive Committee. Wholesale and Market Risk, an independent unit within the Risk function, develops risk management policies and measurement techniques.

Risk limits are determined for each location and, within location, for each portfolio. Limits are set by product and risk type with market liquidity being a principal factor in determining the level of limits set. Limits are set using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value at risk limits at a portfolio level. Similarly, option risks are controlled through full revaluation limits in conjunction with limits on the underlying variables that determine each option's value.

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence (99% for the group). VAR is calculated daily. The group uses a historical simulation model which derives plausible future scenarios from historical market data. Potential movements in market prices are calculated with reference to market data from the last two years. The model used assumes a 1-day holding period, as this reflects the way the risk positions are managed.

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

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

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

Trading

The group's control of market risk is based on restricting individual operations to trading within a list of permissible instruments authorised for each site by Wholesale and Market Risk, and enforcing rigorous new product approval procedures. In particular, trading in the more complex derivative products is concentrated in offices with appropriate levels of product expertise and robust control systems.

In addition, at both portfolio and position levels, market risk in trading portfolios is monitored and controlled using a complementary set of techniques such as VAR and present value of a basis point, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

The total VAR for Global Markets were as follows:

	The group		The Bank	
	2012	2011	**2012**	2011
	HK$m	HK$m	**HK$m**	HK$m
Total VAR				
Year end	**199**	393	**173**	279
Average	**260**	306	**211**	235
Maximum	**473**	463	**357**	326
Minimum	**167**	190	**159**	156
Total interest rate VAR				
Year end	**169**	151	**149**	105
Average	**209**	141	**168**	121
Maximum	**261**	187	**212**	161
Minimum	**169**	108	**137**	92
Total foreign exchange VAR				
Year end	**43**	49	**43**	51
Average	**38**	50	**39**	52
Maximum	**85**	116	**93**	111
Minimum	**23**	28	**22**	29
Total credit spread VAR				
Year end	**121**	343	**69**	196
Average	**177**	246	**110**	166
Maximum	**325**	380	**212**	247
Minimum	**118**	136	**67**	96
Total trading VAR				
Year end	**134**	184	**119**	156
Average	**136**	131	**128**	118
Maximum	**232**	208	**227**	184
Minimum	**89**	73	**84**	69
Interest rate trading VAR				
Year end	**95**	98	**90**	101
Average	**110**	91	**101**	87
Maximum	**159**	150	**142**	120
Minimum	**68**	62	**70**	59
Foreign exchange trading VAR				
Year end	**43**	46	**43**	48
Average	**38**	47	**39**	47
Maximum	**85**	99	**93**	95
Minimum	**23**	24	**22**	27
Credit spread trading VAR				
Year end	**39**	109	**25**	82
Average	**47**	67	**39**	57
Maximum	**98**	115	**82**	96
Minimum	**29**	36	**23**	32
Equity trading VAR[1]				
Year end	**26**	15	**26**	15
Average	**27**	18	**27**	18
Maximum	**54**	37	**54**	37
Minimum	**14**	5	**14**	5

1 *In addition to equity trading positions managed by Global Markets, the group also has exposure to changes in equity prices and interest rates relating to guarantees given to customers who purchase certain HSBC investment contracts. As at 31 December 2012, a 10% decrease in equity prices would reduce profit before tax and net assets by HK$182m (2011: HK$186m) and a 100 basis points decrease in interest rates would reduce profit before tax and net assets by HK$23m (2011: HK$156m).*

52 Risk management *(continued)*

Non-trading portfolios

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

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

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

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

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

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

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

Structural foreign exchange exposure

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

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

Foreign currency investments amounted to the foreign currency equivalent of HK$324,804m (74% of shareholders' funds) at 31 December 2012, an increase of HK$57,422m from HK$267,382m (78% of shareholders' funds) at 31 December 2011. Gains or losses on structural foreign currency exposures are taken to reserves.

The group had the following structural foreign currency exposures that were not less than 10% of the total net structural foreign currency position:

	The group		The Bank	
	LCYm	HK$m	LCYm	HK$m
At 31 December 2012				
Chinese renminbi	**153,638**	**189,446**	**39,447**	**48,641**
At 31 December 2011				
Chinese renminbi	117,895	145,347	32,290	39,809

52 Risk management *(continued)*

d *Operational risk*

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

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

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

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

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

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

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e *Insurance risk*

Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the insurer. The principal insurance risk faced by the group is that, over time, the combined cost of claims, benefits, administration and acquisition of the contracts 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 discretionary participation features, the performance of the assets held to support the liabilities. The severity of the claims and benefits, as well as the timing, is therefore uncertain. Contracts under which the transfer of insurance risk from the policyholder to the group is not significant are classified as investment contracts.

The group manages its insurance risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set limits, risk diversification, pricing guidelines, reinsurance and monitoring of emerging issues, taking into account where appropriate local market conditions and any regulatory requirements that apply.

All insurance products, whether internally manufactured or provided by a third party manufacturer, are reviewed by the Product Management Committee. Several methods are used 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.

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. Insurance events are, by their nature, incorporated with a certain degree of randomness and the actual number of events during any one year may vary from those estimated using established statistical techniques.

Asset and liability management

A principal tool used by the group to manage its exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching. The group actively manages its assets using an approach that considers asset quality, diversification, cash flow matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return within acceptable parameters. The Investment Committee reviews and approves strategic asset allocation on a periodic basis and establishes investment guidelines. The asset and liability management process is also overseen by the Asset and Liability Management Committee of the group's insurance business.

The group establishes asset portfolios for each major insurance product category consistent with local regulatory requirements. The investment policy defines the asset allocation and restrictions with the aim of achieving the target investment return in the long term.

The following table shows the composition of assets and liabilities for each major insurance product category. 93% of both assets and liabilities are derived from Hong Kong.

Statement of financial position of insurance manufacturing subsidiaries by type of contract

	Life linked contracts[1] HK$m	Life non-linked contracts[2] HK$m	Non-life insurance HK$m	Other assets[3] HK$m	Total HK$m
At 31 December 2012					
Financial assets:					
– financial assets designated at fair value	36,837	30,376	–	413	67,626
– derivatives	7	1,017	–	2	1,026
– financial investments	–	175,773	81	12,246	188,100
– other financial assets	963	37,035	324	1,196	39,518
Total financial assets	37,807	244,201	405	13,857	296,270
Reinsurance assets	3,103	1,389	–	1,101	5,593
PVIF[4]	–	–	–	24,425	24,425
Other assets	2	3,941	1	5,595	9,539
Total assets	40,912	249,531	406	44,978	335,827
Liabilities under investment contracts designated at fair value	7,038	29,182	–	–	36,220
Liabilities under insurance contracts	33,948	210,853	120	–	244,921
Deferred tax	–	196	–	4,610	4,806
Other liabilities	–	–	–	4,761	4,761
Total liabilities	40,986	240,231	120	9,371	290,708
Total equity	–	–	–	45,119	45,119
Total equity and liabilities	40,986	240,231	120	54,490	335,827

52 Risk management *(continued)*

	Life linked contracts[1] HK$m	Life non-linked contracts[2] HK$m	Non-life insurance HK$m	Other assets[3] HK$m	Total HK$m
At 31 December 2011					
Financial assets:					
– financial assets designated at fair value	28,067	26,016	404	120	54,607
– derivatives	10	873	–	–	883
– financial investments	4	147,049	1,151	10,843	159,047
– other financial assets	2,086	31,022	1,355	1,271	35,734
Total financial assets	30,167	204,960	2,910	12,234	250,271
Reinsurance assets	6,666	228	395	96	7,385
PVIF[4]	–	–	–	20,232	20,232
Other assets	7	3,419	190	3,879	7,495
Total assets	36,840	208,607	3,495	36,441	285,383
Liabilities under investment contracts designated at fair value	6,633	27,849	–	–	34,482
Liabilities under insurance contracts	30,055	176,324	3,059	–	209,438
Deferred tax	(6)	161	1	3,479	3,635
Other liabilities	–	–	–	2,625	2,625
Total liabilities	36,682	204,334	3,060	6,104	250,180
Total equity	–	–	–	35,203	35,203
Total equity and liabilities	36,682	204,334	3,060	41,307	285,383

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

Underwriting strategy

The group's underwriting strategy seeks diversity to achieve 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 outcomes.

Reinsurance strategy

The group reinsures a portion of the insurance risks it underwrites in order to mitigate its exposures to losses and protect capital resources. The group buys a combination of proportionate and non-proportionate reinsurance to reduce the exposures and uses reinsurance agreements with non-affiliated reinsurers to manage its exposure to losses resulting from certain catastrophes. The group also uses reinsurance to manage financial risk arising from guaranteeing minimum investment performance under a unit-linked insurance product and a traditional non-participating insurance product.

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

Nature of risks covered

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

(i) Insurance contracts – non-linked products

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

(ii) Insurance contracts – unit-linked products

The group writes unit-linked life insurance policies, which typically provide policyholders with life insurance protection and a choice of investment in a variety of funds. Premiums received are deposited into the chosen funds after deduction of premium fees. Other charges for the cost of insurance and administration are deducted from the funds accumulated. Where there is a performance guarantee, the risk is managed through reinsurance.

(iii) Investment contracts – retirement funds with guarantees

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 in which to place their contributions, on which the group provides an investment return or capital protection guarantee for some specific funds. Investment strategy is set with the objective of providing a return that is sufficient to meet at least the minimum guarantee.

(iv) Investment contracts – retirement funds without guarantees

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 in which to place their contributions. The group bears no investment risk under this type of investment contract.

(v) Non-life insurance contracts

The group assumes the risk of loss from persons and organisations relating to property, liability, accident, health, financial or other perils that may arise from an insurable event. The group manages the risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set authority limits, risk diversification, pricing guidelines, reinsurance and monitoring of emerging issues. Following the disposals of non-life businesses during 2012, this risk is minimal.

Concentrations of insurance risks

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

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

The policyholders of the insurance contracts issued by the group, its associates and joint ventures, are mainly residents of Hong Kong, Macau, mainland China, Taiwan, Singapore, Malaysia, Vietnam, India and South Korea, with the majority in Hong Kong.

To determine the concentration of insurance risks and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the group. Total loss is estimated based on the chosen stress level. Details of the group's reinsurance strategy are disclosed on page 187.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore 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 and a range of assumptions which mainly include interest rate and mortality levels. The process used to determine the assumptions is intended to result in stable and prudent estimates of future outcomes. This is achieved by adopting relatively conservative assumptions which can withstand a reasonable range of fluctuation of actual experience. An annual review of the relevant experience is performed to assess the adequacy of margins that exist between the assumptions adopted and the most likely estimate of future outcome. Since the group is not exposed to significant insurance risk on investment contracts, they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 34.

Financial risks

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

The group is also exposed to investment return guarantee risk for certain investment contracts issued to policyholders. 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 invest in fixed income securities and adopt a matching approach whereby assets held are managed to meet the liabilities 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 manufacturing subsidiaries at 31 December 2012 by type of liability, and provides a view of the exposure to financial risk:

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

Financial assets held by insurance manufacturing subsidiaries

	At 31 December 2012				
	Life linked contracts HK$m	**Life non-linked contracts HK$m**	**Non-life insurance HK$m**	**Other assets HK$m**	**Total HK$m**
Financial assets designated at fair value					
– Debt securities	**10**	**15,146**	**–**	**413**	**15,569**
– Equity securities	**36,827**	**15,230**	**–**	**–**	**52,057**
	36,837	**30,376**	**–**	**413**	**67,626**
Financial investments					
Held-to-maturity:					
– Debt securities	**–**	**151,818**	**–**	**12,001**	**163,819**
Available-for-sale:					
– Treasury bills	**–**	**–**	**–**	**–**	**–**
– Debt securities	**–**	**23,952**	**81**	**191**	**24,224**
– Equity securities	**–**	**3**	**–**	**54**	**57**
	–	**23,955**	**81**	**245**	**24,281**
Derivatives	**7**	**1,017**	**–**	**2**	**1,026**
Other financial assets	**963**	**37,035**	**324**	**1,196**	**39,518**
	37,807	**244,201**	**405**	**13,857**	**296,270**

	At 31 December 2011				
	Life linked contracts HK$m	Life non-linked contracts HK$m	Non-life insurance HK$m	Other assets HK$m	Total HK$m
Financial assets designated at fair value					
– Debt securities	–	13,815	404	120	14,339
– Equity securities	28,067	12,201	–	–	40,268
	28,067	26,016	404	120	54,607
Financial investments					
Held-to-maturity:					
– Debt securities	–	131,932	1,033	10,097	143,062
Available-for-sale:					
– Treasury bills	–	–	–	–	–
– Debt securities	–	15,115	118	728	15,961
– Equity securities	4	2	–	18	24
	4	15,117	118	746	15,985
Derivatives	10	873	–	–	883
Other financial assets	2,086	31,022	1,355	1,271	35,734
	30,167	204,960	2,910	12,234	250,271

The table demonstrates that for linked contracts, the group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 12.8% of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2012 (2011: 12.1%). The table also shows that approximately 68.7% of financial assets were invested in debt securities at 31 December 2012 (2011: 69.3%) with 17.6% (2011: 16.1%) invested in equity securities.

Market risk

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

52 Risk management *(continued)*

Interest rate risk

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

For participating products, interest rate risk can also be mitigated through sharing of risk with policyholders under the discretionary participation mechanism.

A shift in interest yield curves as at 31 December 2012 in all territories in which the group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

	31 December 2012		31 December 2011	
	Impact on profit for the year HK$m	**Impact on net assets HK$m**	Impact on profit for the year HK$m	Impact on net assets HK$m
+ 100 basis points shift in yield curves	**1,096**	**(1,238)**	1,065	(390)
– 100 basis points shift in yield curves	**(1,424)**	**1,032**	(977)	547

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

Equity and other price risks

The portfolio of securities, including equities and other assets, which the group carries on the balance sheet at fair value, has exposure to price risk. This risk is defined as the potential loss in market value resulting from an adverse change in prices. The risk is mainly mitigated through dynamic asset allocation, portfolio diversification and sharing the risk with policyholders through the discretionary participation feature. Portfolio characteristics are analysed regularly and these risks are regularly reviewed. The group's investment portfolios are diversified across industries and asset classes, with concentrations in any one company, industry or asset class limited by parameters established by senior management, as well as by statutory requirements.

The following table illustrates the impact on the profit for the year and net assets of a 10% variance in equity prices:

	31 December 2012		31 December 2011	
	Impact on profit for the year HK$m	**Impact on net assets HK$m**	Impact on profit for the year HK$m	Impact on net assets HK$m
10% increase in equity prices	**515**	**515**	629	629
10% decrease in equity prices	**(518)**	**(518)**	(1,075)	(1,076)

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 sensitivities reflect the established investment risk sharing mechanism with policyholder for participating products but do not allow for the effect of other management actions which may mitigate the equity price decline, nor for any resultant changes in policyholder behaviour, that might accompany such a fall.

Foreign currency risk

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

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

Credit risk

The group's portfolios of fixed income securities, and to a lesser extent short-term and other investments, are subject to credit risk. This risk is defined as the potential financial loss resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place and limits are established to manage credit quality and concentration risk. The following table presents the analysis of the treasury bills, other eligible bills and debt securities within the group's insurance business. The definition of the four credit quality classifications is included on page 167. Only assets supporting non-linked liabilities are included in the table as financial risk on assets supporting linked liabilities is predominantly borne by the policyholders. 88.4% (2011: 91.1%) of the assets included in the table are invested in investments rated as 'Strong'.

	Neither past due nor impaired						
	Strong HK$m	Medium HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
31 December 2012							
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	**13,755**	**1,391**	**–**	**–**	**–**	**–**	**15,146**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**13,755**	**1,391**	**–**	**–**	**–**	**–**	**15,146**
Financial investments	**154,799**	**21,052**	**–**	**–**	**–**	**–**	**175,851**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**154,799**	**21,052**	**–**	**–**	**–**	**–**	**175,851**
Supporting shareholders funds[1]							
Financial assets designated at fair value	**374**	**39**	**–**	**–**	**–**	**–**	**413**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**374**	**39**	**–**	**–**	**–**	**–**	**413**
Financial investments	**10,960**	**1,232**	**–**	**–**	**–**	**–**	**12,192**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**10,960**	**1,232**	**–**	**–**	**–**	**–**	**12,192**
Total							
Financial assets designated at fair value	**14,129**	**1,430**	**–**	**–**	**–**	**–**	**15,559**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**14,129**	**1,430**	**–**	**–**	**–**	**–**	**15,559**
Financial investments	**165,759**	**22,284**	**–**	**–**	**–**	**–**	**188,043**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**165,759**	**22,284**	**–**	**–**	**–**	**–**	**188,043**

52 Risk management *(continued)*

31 December 2011	Neither past due nor impaired Strong HK$m	Medium HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	13,238	981	–	–	–	–	14,219
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,238	981	–	–	–	–	14,219
Financial investments	134,738	13,460	–	–	–	–	148,198
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	134,738	13,460	–	–	–	–	148,198
Supporting shareholders funds[1]							
Financial assets designated at fair value	96	24	–	–	–	–	120
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	96	24	–	–	–	–	120
Financial investments	9,837	988	–	–	–	–	10,825
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	9,837	988	–	–	–	–	10,825
Total							
Financial assets designated at fair value	13,334	1,005	–	–	–	–	14,339
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,334	1,005	–	–	–	–	14,339
Financial investments	144,575	14,448	–	–	–	–	159,023
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	144,575	14,448	–	–	–	–	159,023

1 *Shareholders' funds comprise solvency and unencumbered assets.*

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 amounts due from reinsurers. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries was as follows:

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong HK$m	Medium HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
31 December 2012							
Linked insurance contracts	**2**	**3,101**	**–**	**–**	**–**	**–**	**3,103**
Non-linked insurance contracts	**1,389**	**–**	**–**	**–**	**–**	**–**	**1,389**
Total	**1,391**	**3,101**	**–**	**–**	**–**	**–**	**4,492**
Reinsurance debtors	**23**	**1,020**	**–**	**58**	**–**	**–**	**1,101**
31 December 2011							
Linked insurance contracts	3	6,663	–	–	–	–	6,666
Non-linked insurance contracts	428	194	–	1	–	–	623
Total	431	6,857	–	1	–	–	7,289
Reinsurance debtors	27	18	–	51	–	–	96

The group has sold a unit-linked life insurance product which provides guaranteed minimum death benefits and guaranteed minimum accumulated benefits which are underwritten by the group but reinsured by a third party. The group has a credit risk exposure in respect of this third party's ability to meet its reinsurance obligation. At 31 December 2012, the exposure to the third party was HK$3,101m (2011: HK$6,663m).

Liquidity risk

There are three components of liquidity risk. The first of these arises in normal market conditions and is referred to as funding liquidity risk, specifically, the capacity to raise sufficient cash when needed to meet payment obligations. Secondly, there is market liquidity risk where the size of a particular holding may be sufficiently large that a sale cannot be completed at or around the market price. Finally, there is standby liquidity risk which refers to the capacity to meet payment conditions in abnormal conditions.

The group has to meet daily calls on its cash resources, notably from claims arising on its insurance and investment contracts and 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 surrender penalties and market adjustment clauses are used to defray costs of unexpected cash requirements.

52 Risk management *(continued)*

The following table shows the expected maturity of insurance contract liabilities at 31 December 2012:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year HK$m	1-5 years HK$m	5-15 years HK$m	Over 15 years HK$m	Total HK$m
At 31 December 2012					
Non-life insurance	**98**	**22**	**1**	**–**	**121**
Life insurance (non-linked)	**28,558**	**86,803**	**168,809**	**203,753**	**487,923**
Life insurance (linked)	**4,213**	**8,073**	**42,297**	**84,029**	**138,612**
	32,869	**94,898**	**211,107**	**287,782**	**626,656**
At 31 December 2011					
Non-life insurance	1,782	834	388	56	3,060
Life insurance (non-linked)	10,490	85,770	148,983	178,200	423,443
Life insurance (linked)	3,538	10,824	39,266	98,261	151,889
	15,810	97,428	188,637	276,517	578,392

Remaining contractual maturity of investment contract liabilities

At 31 December 2012	Linked investment contracts HK$m	Non-linked investment contracts HK$m	Investment contracts with DPF HK$m	Total HK$m
Remaining contractual maturity				
– due within 1 year	**115**	**25**	**29**	**169**
– due between 1 and 5 years	**–**	**–**	**–**	**–**
– due between 5 and 10 years	**–**	**–**	**–**	**–**
– undated[1]	**6,923**	**29,156**	**–**	**36,079**
	7,038	**29,181**	**29**	**36,248**
At 31 December 2011				
Remaining contractual maturity				
– due within 1 year	216	21	60	297
– due between 1 and 5 years	–	–	26	26
– due between 5 and 10 years	259	–	–	259
– undated[1]	6,157	27,828	–	33,985
	6,632	27,849	86	34,567

1 *In most cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. The surrender values may be significantly lower than the amounts shown above.*

52 Risk management *(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 2012 was HK$24,425m (2011: HK$20,232m), representing the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

The calculation of the PVIF asset was refined in 2011 by incorporating explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments to the discount rate. The valuation now includes 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 have been reduced as a result of removing the implicit adjustments. It should be noted that these refinements introduced greater volatility within the insurance results in response to changes in market conditions.

PVIF can be stress-tested to assess the sensitivity of the value of life business to adverse movements of different risk factors. The following table shows the effect on the PVIF as at 31 December 2012 of changes in the main economic assumption:

	Impact on results	
	2012	2011
	HK$m	HK$m
+ 100 basis points shift in risk-free rate	**1,111**	1,101
– 100 basis points shift in risk-free rate	**(1,153)**	(687)

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 sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products, but do not incorporate other actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

Non-economic assumptions

Non-economic assumptions including, for non-life business, claims costs and expense rates and, for life business, mortality and/or morbidity, lapse rates and expense rates, are also used for the determination of the policyholder liabilities and PVIF, subject to any relevant local regulatory requirements. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2012 across all insurance manufacturing subsidiaries is as follows:

	Impact on 2012 results		Impact on 2011 results	
	Profit after tax	**Net assets**	Profit after tax	Net assets
	HK$m	**HK$m**	HK$m	HK$m
20% increase in claims costs	**(3)**	**(3)**	(194)	(194)
20% decrease in claims costs	**3**	**3**	194	194
10% increase in mortality and/or morbidity rates	**(362)**	**(362)**	(406)	(406)
10% decrease in mortality and/or morbidity rates	**374**	**374**	407	407
50% increase in lapse rates	**(1,048)**	**(1,048)**	(605)	(605)
50% decrease in lapse rates	**2,328**	**2,328**	1,524	1,524
10% increase in expense rates	**(275)**	**(275)**	(286)	(286)
10% decrease in expense rates	**281**	**281**	285	285

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 sensitivities reflect the established risk sharing mechanism with policyholder for participating products but do not incorporate other actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

52 Risk management *(continued)*

f *Capital management*

Our approach to capital management is driven by our strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which we operate.

It is our objective to maintain a strong capital base to support the development of our business and to meet regulatory capital requirements at all times. To achieve this, our policy is to hold capital in a range of different forms and all capital raising is agreed with major subsidiaries as part of their individual and the group's capital management processes.

Our capital management process is articulated in our annual group capital plan which is approved by the Board. The plan is drawn up with the objective of maintaining both an appropriate amount of capital and an optimal mix between the different components of capital. Each subsidiary manages its own capital to support its planned business growth and meet its local regulatory requirements within the context of the approved annual group capital plan. In accordance with HSBC Group's Capital Management Framework, capital generated by subsidiaries in excess of planned requirements is returned to the Bank, normally by way of dividends.

The Bank is primarily the provider of equity capital to its subsidiaries and these investments are substantially funded by the Bank's own capital issuance and profit retention. As part of its capital management process, 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: share capital, retained profits, other reserves, preference shares and subordinated liabilities. Capital also includes the collective impairment allowances held in respect of loans and advances.

Externally imposed capital requirements

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

Basel II enhancements (commonly known as Basel 2.5) took effect from 1 January 2012. The main changes include raising banks' capital requirements for trading and securitisation exposures, providing supplemental guidance on risk management principles and strengthening disclosure in corresponding areas. The resulting effect was an increase in risk weighted assets for market risk.

The group uses the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures and the internal ratings-based (securitisation) approach to determine credit risk for its banking book 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. As opposed to the standardised (market risk) approach that was used at 31 December 2011, the group has adopted an internal models approach to calculate the general market risk and specific risk for the risk category of equity exposures. The group also uses an internal models approach to calculate its market risk in respect of specific risk for interest rate exposures. The group uses the standardised (market risk) approach for calculating other market risk positions as well as trading book securitisation exposures, and the standardised (operational risk) approach to calculate its operational risk.

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

Notes on the Financial Statements (continued)

52 Risk management *(continued)*

Basel III

In December 2010, the Basel Committee 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 Basel Committee 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 common equity tier 1 (CET1) requirement of 4.5% and additional capital conservation buffer requirement of 2.5%, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019. 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 Basel Committee issued further minimum requirements in January 2011 to ensure that all classes of capital instruments fully 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 securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

The provisions of the Banking (Capital) (Amendment) Rules 2012 ('BCAR 2012') came into effect on 1 January 2013 to implement the first phase of Basel III capital standards in Hong Kong ('Basel III rules'). 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.

53 Special purpose entities

The group enters into certain transactions with customers in the ordinary course of business which involve the use of special purpose entities ('SPEs') to facilitate or secure customer transactions. The group structures that use SPEs are authorised centrally prior to being established to ensure appropriate purpose and governance. The activities of SPEs administered by the group are closely monitored by senior management. The most significant categories of complex or non-transparent structures using SPEs are discussed in more detail below.

Structured credit transactions

The group provides structured credit products to third-party professional and institutional investors who wish to obtain exposure to a reference portfolio of debt instruments.

In such structures, the investor receives returns referenced to the underlying portfolio by purchasing notes issued by the SPEs. The group enters into contracts with the SPEs, generally in the form of derivatives, in order to pass the required risks and rewards of the reference portfolios to the SPEs.

In certain transactions the group is exposed to risk often referred to as gap risk. Gap risk typically arises in transactions where the aggregate potential claims against the SPE by the group pursuant to one or more derivatives could be greater than the value of the collateral held by the SPE and securing such derivatives. The group often mitigates such gap risk by ensuring high quality collateral, hedging the risk, or incorporating features allowing managed liquidation of the portfolio.

Securitisations

The group also uses SPEs to securitise customer loans and advances that it has originated in order to diversify its sources of funding for asset origination and/or for capital efficiency purposes. In such cases, the loans and advances are transferred by the group to the SPEs for cash, and the SPEs issue debt securities to investors to fund the cash purchases. The group may also act as a derivative counterparty or provide a guarantee. Credit enhancements to the underlying assets may be provided to obtain investment grade ratings on the senior debt issued by the SPEs. These SPEs are consolidated when the group is exposed to the majority of risks and rewards of ownership.

The group's exposure is the aggregate of any holdings of notes issued by these vehicles, the reserve account positions intended to provide credit support under certain pre-defined circumstances to senior note holders and any derivatives or guarantee provided. Off balance sheet financial guarantees are disclosed in note 44 (b).

53 Special purpose entities *(continued)*

Third-party financing SPEs

The group also transacts with third party SPEs in the normal course of business for a number of purposes, for example, to provide finance to public and private sector infrastructure projects, for asset and structured finance transactions and for customers to raise finance against security.

The assets are generally ring-fenced by the SPE and, in most cases, the customer, a sponsor or third party provides some credit enhancement or guarantee in the structure. The group generally provides financing in the form of senior lending or debt instruments but may also enter into derivative contracts with these SPEs. These SPEs are consolidated when the group is exposed to the majority of risks and rewards of ownership.

The derivative and lending exposures are generally secured by the SPE's assets, with credit enhancement and/or guarantees provided by third parties. The group's risk in relation to the derivative contracts and trading positions with these SPEs is managed within the group's market risk framework (see 'Market risk' in note 52c). Credit risk is managed within the group's credit risk framework (see 'Credit risk' in note 52a).

54 Legal proceedings

US regulatory and law enforcement investigations

In December 2012, HSBC Holdings plc, the Bank's ultimate parent company, entered into agreements to achieve a resolution with US and UK government agencies that have investigated HSBC's conduct related to inadequate compliance with anti-money laundering ('AML'), US Bank Secrecy Act ('BSA') and sanctions laws. This was as a result of investigations by the US Department of Justice ('DoJ'), the Federal Reserve, the Office of the Comptroller of the Currency and the US Department of Treasury's Financial Crimes Enforcement Network in connection with AML/BSA compliance in various parts of the HSBC Group. As part of the resolution, HSBC and HSBC Bank USA, N.A. entered into a deferred prosecution agreement (the 'US DPA') with the DoJ, the United States Attorney's Office for the Eastern District of New York, and the United States Attorney's Office for the Northern District of West Virginia, and a deferred prosecution agreement with the New York County District Attorney, and consented to a cease and desist order with the Federal Reserve.

HSBC also entered into an undertaking with the UK Financial Services Authority ('FSA') to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term. Under these agreements, HSBC will continue to cooperate fully with US and UK regulatory and law enforcement authorities and take further action to strengthen their compliance policies and procedures. Over the five-year term of the agreements with the DoJ and FSA, an independent monitor will evaluate HSBC's progress in fully implementing these and other measures it recommends, and will produce regular assessments of the effectiveness of HSBC's compliance function. If HSBC fulfils all of the requirements imposed by the US DPA and other agreements, the DoJ's charges against it will be dismissed at the end of the five-year period.

The above agreements cover the activities of all entities in the HSBC Group, including the Bank and its subsidiaries. As at 31 December 2012, there has been no specific action taken against the Bank or any of its subsidiaries in relation to the above investigations, and no financial penalties have been incurred and none are anticipated.

Other matters

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

Notes on the Financial Statements (continued)

55 Ultimate holding company

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

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

56 Nature of business

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

57 Events after the balance sheet date

On 5 December 2012, we announced an agreement to sell our shares in Ping An. This transaction completed on 6 February 2013. See note 28 for further details on the transaction.

On 7 January 2013, Industrial Bank Co., Ltd. ('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 it is no longer in a position to exercise significant influence over Industrial Bank and ceased to account for the investment as an associate from that date, giving rise to an accounting gain of approximately HK$9.5bn. Thereafter, the holding is recognised as an available-for-sale financial investment.

58 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 4 March 2013.

EXHIBIT B

RISK MANAGEMENT SYSTEM

The information in this Exhibit B describes the risk management system of the Issuer and references herein to the "**HSBC Group**" or the "**group**" are to the Issuer and its subsidiaries.

The information in this Exhibit B has been extracted from the Annual Report and Accounts 2012 of the Issuer. Reference to page numbers (i.e. the pages numbers which appear on the bottom of the pages) in this Exhibit B are to pages of the Annual Report and Accounts 2012. The extracts set out in this Exhibit B are not complete and reference should be made to the Annual Report and Accounts 2012 which is available for inspection at the Issuer's office at HSBC Main Building, 1 Queen's Road Central, Hong Kong.

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

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

Credit risk, liquidity risk, market risk, operational risk, insurance risk and capital management are discussed in detail in Note 52 to the Financial Statements on pages 164 to 198.

Financial Review (continued)

Market Risk Management

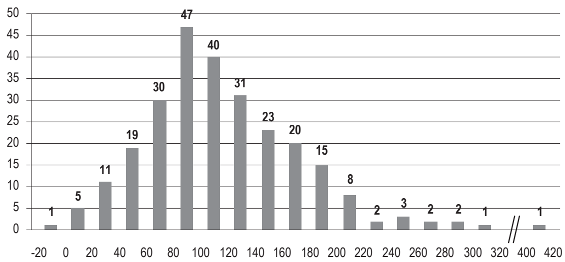
The nature of market risk and the principal tool used to monitor and limit market risk exposure (value at risk) are discussed in Note 52 on the Financial Statements on pages 181 to 184.

The average daily revenue earned from market risk-related treasury activities in 2012, including accrual book net interest income and funding related to dealing positions, was HK$117m compared with HK$113m in 2011. The standard deviation of these daily revenues was HK$58m (HK$53m for 2011).

An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on 1 day in 2012. The most frequent result was a daily revenue of between HK$80m and HK$100m with 47 occurrences. The highest daily revenue was HK$417m. The most frequent result in 2011 was a daily revenue of between HK$80m and HK$100m with 45 occurrences. The highest daily revenue in 2011 was HK$241m.

Daily distribution of market risk revenues 2012

Number of days

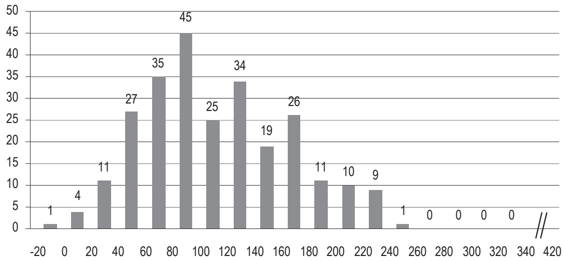


Revenues *(HK$m)*

Profit and loss frequency

Daily distribution of market risk revenues 2011

Number of days



Revenues *(HK$m)*

Profit and loss frequency

Reputational Risk Management

Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events.

Reputational risks are considered and assessed by senior management. Standards on all major aspects of business are set by the HSBC Group Head Office. These policies, which form an integral part of the internal control systems, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies set out operational procedures in all areas of reputational risk, including money laundering deterrence, environmental impact, anti-corruption measures and employee relations.

Internal controls are an integral part of how the group conducts its business. HSBC's manuals and statements of policy are the foundation of these internal controls. There is a strong process in place to ensure controls operate effectively. Any significant failings are reported through control mechanisms, internal audit and compliance functions to the group's Audit Committee and senior management. In addition, all businesses and major functions are required to review their control procedures and to make regular reports about any losses arising from operational risks.

Management in all operating entities is required to establish a strong internal control structure to minimise the risk of operational and financial failure, and to ensure that a full appraisal of reputational implications is made before strategic decisions are taken. The HSBC Group's internal audit function monitors compliance with policies and standards.

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