BASE LISTING DOCUMENT

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 warrants on single equities ("**Call Warrants**"), put warrants on single equities ("**Put Warrants**"), call warrants on indices ("**Index Call Warrants**"), put warrants on indices ("**Index Put Warrants**"), call warrants on unit funds ("**Unit Fund Call Warrants**"), put warrants on unit funds ("**Unit Fund Put 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 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 of Hong Kong Limited (the "**stock exchange**").

Hong Kong Exchanges and Clearing Limited 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 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. We accept full responsibility for the accuracy of the information contained in this document and confirm, having made all reasonable enquiries, that to the best of our knowledge and belief there are no other facts the omission of which would make any statement in 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. Investors are warned that the price of our structured products may fall in value as rapidly as it may rise and holders may sustain a total loss of their 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 structured products constitute general unsecured contractual obligations of the Issuer and of no other person and if you purchase the structured products you are relying upon the Issuer's creditworthiness and have no rights under the structured products against, as applicable, the underlying, any company which has issued the underlying or any company which sponsors the underlying or whose securities are comprised in the underlying.

Dated 26 April 2012

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.

This base listing document may be updated from time to time, in which case we will publish an addendum.

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 take 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 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) 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 warrants on single equities ("**call warrants**");

(b) put warrants on single equities ("**put warrants**");

(c) call warrants on a single index ("**index call warrants**");

(d) put warrants on a single index ("**index put warrants**");

(e) call warrants on a single unit fund ("**unit fund call warrants**"); and

(f) put warrants on a single unit fund ("**unit fund put 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 unit funds ("**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 outstanding, unsecured and unsubordinated obligations.

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 Hong Kong Securities Clearing Company Limited ("**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 Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited 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).
What will a supplemental listing document specify?	The supplemental listing document will, amongst other things, summarise the terms of the series of structured products being offered, 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 for the series of structured products offered, and the basis on which the 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 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 Hong Kong Exchanges and Clearing Limited, 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.

The following summary does not necessarily set out all the risks related to the structured products and you should not rely on it without reference to the relevant conditions of this document. If you have any concerns or doubts about the structured products, you should obtain independent professional advice.

General Risk Factors relating to us and our Structured Products

(1) Our creditworthiness

If you purchase our structured products, you rely on our creditworthiness 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).

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 111 of this base listing document and the section headed "Further information" of the relevant supplemental listing document) because:

- a credit rating is not a recommendation to buy, sell or hold the structured products;
- ratings of issuers 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 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.

(2) 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 selling or exercising any rights under our structured products, you should carefully consider, among other things, (i) the trading price of the structured products; (ii) the value or level 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.

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

We intend to apply to list each series of our structured products on the stock exchange. 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.

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

The structured products constitute the direct, general, unsecured and unsubordinated contractual obligations of us and of no other person and shall rank equally (*pari passu*) with our other existing and future unsecured, unsubordinated contractual 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. A reduction in our rating by any rating agency could result in a reduction in the trading value of our structured products.

(5) 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.

(6) 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 conditions. We will not compensate you for any loss you suffer as a result of any time lag.

(7) 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.

(8) 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.

(9) 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 of the underlying to move one way but it moves in the opposite direction.

(10) 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. In the ordinary course of our business, we may effect transactions on our own account or for the account of our customers and hold positions in the underlying shares.

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

Our structured products will be issued in global registered form, and consequently HKSCC Nominees Limited will be the only legal owner 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 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) in accordance with the conditions to HKSCC Nominees Limited as the registered holder of the structured products. The amounts will be delivered to you or your custodian/broker through CCASS participants in accordance with the general rules of CCASS and the CCASS operational procedures in effect from time to time.

(12) There may be an exchange rate risk

You should note that there may be an exchange rate risk in the case of structured products where the cash settlement amount is converted from a foreign currency into Hong Kong dollars, for example, where the underlying is denominated in a currency other than Hong Kong dollars.

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.

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

In the case of index-linked structured products, a level for the index may be published by the index compiler (as defined in the relevant 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 conditions) and there is no market disruption event (as defined in the relevant 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.

(14) 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.

(15) 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.

(16) 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 31 December 2016 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 31 December 2012 or are materially modified from that date 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. 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, if FATCA is implemented as currently proposed by the U.S. Internal Revenue Service, receive less settlement amount than expected.

FATCA is particularly complex and its application is uncertain at this time. The above description is based in part on proposed regulations and official guidance that is subject to change. The application of FATCA to structured products issued after 31 December 2012 (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.

(17) 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 109 of this base listing document for further information.

(18) 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 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 warrant 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).

(19) 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.

(20) 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.

(21) 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.

(22) 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 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 different replication strategy by investing in derivative instruments designed to replicate the performance of the index and such ETFs will face the credit risk of its counterparties issuing such derivative instruments. Accordingly, investors in structured products the return on which is linked to such synthetic ETFs are also exposed to the credit risk of the counterparties who issued the derivatives in addition to the risks associated with the underlying indices the performance of which the ETFs are designed to replicate.

Risk Factors relating to CBBCs

(23) 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. If a mandatory call event (as defined in the relevant conditions) occurs, the CBBCs will automatically expire. The CBBCs may become worthless.

(24) 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 conditions), the trading price and theoretical value of the CBBC will likely be more volatile. 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 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.

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

The initial funding cost applicable to the CBBCs as of the launch date will be specified in the relevant supplemental listing document for the relevant series. The funding cost of the CBBCs may fluctuate throughout the life of the CBBCs and will depend partly upon the length of the period remaining to expiration and prevailing interest rates. The purchase price paid by you will include such funding costs. When a mandatory call event occurs, the residual value will not contain a refund of any part of such cost. Generally speaking, the longer the period remaining to expiration, or the higher the prevailing interest rates, the greater the funding cost element.

(26) 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 (the occurrence of any such event to be agreed between the issuer and the stock exchange on the trading day following the occurrence of the mandatory call event in accordance with procedures prescribed by the stock exchange from time to time):

(i) the stock exchange's system malfunctioning or other internal issues (e.g. the call level or price or other parameters are erroneously set up in the stock exchange's system); or

(ii) manifest errors caused by other relevant price sources where applicable (e.g. miscalculation of index level by the index compiler).

(27) Additional risk factors relating to CBBCs

You should note that when a mandatory call event occurs in the pre-opening session or the closing auction session (as the case may be) of the stock exchange, all trades in the CBBCs concluded via auction during the order matching period will be cancelled, and all manual trades concluded after the determination of the final indicative equilibrium price will not be recognised. If the mandatory call event occurs in the continuous trading session, all trades concluded via auto-matching or manually after the mandatory call event ("**post MCE trades**") will be cancelled. Announcements relating to a mandatory call event may also be delayed due to technical errors or system failures.

Neither the stock exchange nor us (or any of our group companies, subsidiaries or affiliates) shall be liable for any loss or damage suffered by you arising from or in connection with any mandatory call event, the suspension of trading or the non-recognition of post MCE trades.

The relevant 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE CALL WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. 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 price 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 is scheduled to open for dealings in Hong Kong (as defined below) and banks are open for business in Hong Kong;

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

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

"**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 or if such date is not a Business Day the immediately succeeding Business Day;

"**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 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 determined Exercise Expenses shall be despatched not later than three CCASS Settlement Days following the Expiry Date ("**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:

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

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

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:

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

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 Exercise Price in accordance with the following formula:

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

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

(c) *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 Hong Kong dollar 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 Hong Kong Dollars 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 script 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:

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

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 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.

(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 Hong Kong 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 Hong Kong 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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant conditions and not otherwise defined therein shall have the meaning given to them in the relevant supplemental listing document.

TERMS AND CONDITIONS OF THE PUT WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. 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 price 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 is scheduled to open for dealings in Hong Kong (as defined below) and banks are open for business in Hong Kong;

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

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

"**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 or if such date is not a Business Day the immediately succeeding Business Day;

"**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 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 determined Exercise Expenses shall be despatched not later than three CCASS Settlement Days following the Expiry Date ("**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:

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

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:

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:

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

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

(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 Hong Kong dollar 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 Hong Kong Dollars 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 script 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:

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

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 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.

(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 Hong Kong 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 Hong Kong 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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant 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 CALL WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. 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 is scheduled to open for dealings in Hong Kong (as defined below) and banks are open for business in Hong Kong;

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

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

"**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;

(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**" means Hong Kong dollars, save as otherwise specified in the relevant Supplemental Listing Document;

"**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 determined Exercise Expenses shall be despatched not later than three CCASS Settlement Days following the Valuation Date ("**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/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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant 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 PUT WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. 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 "**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 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 is scheduled to open for dealings in Hong Kong (as defined below) and banks are open for business in Hong Kong;

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

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

"**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;

(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**" means Hong Kong dollars, save as otherwise specified in the relevant Supplemental Listing Document;

"**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 determined Exercise Expenses shall be despatched not later than three CCASS Settlement Days following the Valuation Date ("**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 may, if applicable, 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 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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant 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 CALL WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. 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 price 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 is scheduled to open for dealings in Hong Kong (as defined below) and banks are open for business in Hong Kong;

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

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

"**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 or if such date is not a Business Day the immediately succeeding Business Day;

"**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 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 determined Exercise Expenses shall be despatched not later than three CCASS Settlement Days following the Expiry Date ("**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:

Adjusted Entitlement = Adjustment Component x 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:

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

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:

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

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

(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 Hong Kong dollar 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 Hong Kong Dollars 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 script 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:

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

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 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.

(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 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, 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 Hong Kong 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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant 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 PUT WARRANTS (CASH SETTLED)

1. Form, Status, Transfer and Title

(a) *Form*. 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 price 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 is scheduled to open for dealings in Hong Kong (as defined below) and banks are open for business in Hong Kong;

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

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

"**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 or if such date is not a Business Day the immediately succeeding Business Day;

"**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 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 determined Exercise Expenses shall be despatched not later than three CCASS Settlement Days following the Expiry Date ("**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:

Adjusted Entitlement = Adjustment Component x 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:

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

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:

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

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

(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 Hong Kong dollar 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 Hong Kong Dollars 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 script 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:

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

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 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.

(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 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, 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 Hong Kong 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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant 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 is scheduled to open for dealings in Hong Kong (as defined below) 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 Bear CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

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

(2) 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:

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

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) on the Valuation Date, subject to any adjustments as determined by the Issuer in accordance with the Conditions;

"**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 or, if such day is not a Business Day, the immediately succeeding Business Day;

"**IEP**" means the indicative equilibrium price, as determined in accordance with the Rules of the Exchange (the "**Trading Rules**");

"**Mandatory Call Event**" occurs:

(1) 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; and

(2) 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;

"**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 (i) if the Mandatory Call Event occurs in the pre-opening session or the closing auction session (if applicable), as the case may be, of the Stock Exchange, all trades in the CBBCs concluded via auction during the order matching period and all manual trades concluded after the determination of the final IEP; or (ii) if the Mandatory Call Event occurs in the continuous trading session of the Stock Exchange, all trades concluded via auto-matching or manually after the 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 highest Spot Price (in respect of a series of Bear CBBCs) or the lowest Spot Price (in respect of a series of Bull CBBCs) of the underlying Shares available during a MCE Valuation Period:

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

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

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

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

"**Settlement Currency**" means Hong Kong dollars, unless otherwise specified in the relevant Supplemental Listing Document;

"**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 meanings 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 not later than three CCASS Settlement Days following the Price Determination Date or the Valuation Date, as the case may be ("**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:

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

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

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

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:

Adjusted Entitlement = Adjustment Component x 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:

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

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

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 Hong Kong dollar 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 Hong Kong Dollars 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 script 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:

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

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

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 Hong Kong 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 Hong Kong 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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant 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 is scheduled to open for dealings in Hong Kong (as defined below) and banks are open for business in Hong Kong;

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

"**Cash Settlement Amount**" means:

(1) 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:

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

(2) 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:

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

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;

"**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 of the Exchange;

"**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 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; and

(2) 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;

"**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;

"**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 (i) if the Mandatory Call Event occurs in the pre-opening session or the closing auction session (if applicable), as the case may be, of the Stock Exchange, all trades in the CBBC concluded via auction during the order matching period and all manual trades concluded after the determination of the final IEP; or (ii) if the Mandatory Call Event occurs in the continuous trading session of the Stock Exchange, all trades concluded via auto-matching or manually after the 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 highest Spot Level (in respect of a series of Bear CBBCs) or the lowest Spot Level (in respect of a series of Bull CBBCs) of the Index available during a MCE Valuation Period:

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

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

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

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

"**Settlement Currency**" means Hong Kong dollars, unless otherwise specified in the relevant Supplemental Listing Document;

"**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 not later than three CCASS Settlement Days following the Price Determination Date or the Valuation Date, as the case may be ("**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 on the basis of its good faith estimate of the Closing Level that would have prevailed on that day but for the occurrence of the Market Disruption Event provided that 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 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.

(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 contracts 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 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 conditions, replace or modify the relevant conditions for the purpose of such series of structured products. Capitalised terms used in the relevant 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 is scheduled to open for dealings in Hong Kong (as defined below) 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 Bear CBBCs and in respect of every Board Lot, an amount in the Settlement Currency calculated by the Issuer as equal to:

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

(2) 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:

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

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) on the Valuation Date, subject to any adjustments as determined by the Issuer in accordance with the Conditions;

"**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 or, if such day is not a Business Day, the immediately succeeding Business Day;

"**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 of the Exchange (the “**Trading Rules**”);

“**Mandatory Call Event**” occurs:

(1) 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; and

(2) 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;

“**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 (i) if the Mandatory Call Event occurs in the pre-opening session or the closing auction session (if applicable), as the case may be, of the Stock Exchange, all trades in the CBBC concluded via auction during the order matching period and all manual trades concluded after the determination of the final IEP; or (ii) if the Mandatory Call Event occurs in the continuous trading session of the Stock Exchange, all trades concluded via auto-matching or manually after the 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 highest Spot Price (in respect of a series of Bear CBBCs) or the lowest Spot Price (in respect of a series of Bull CBBCs) of the underlying Units available during a MCE Valuation Period:

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

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

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

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

"**Settlement Currency**" means Hong Kong dollars, unless otherwise specified in the relevant Supplemental Listing Document;

"**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 not later than three CCASS Settlement Days following the Price Determination Date or the Valuation Date, as the case may be ("**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:

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

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

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:

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

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

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 Hong Kong dollar 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 Hong Kong Dollars 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 script 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:

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

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

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 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, 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 Hong Kong 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 complete 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 seven other countries around the world. Employing some 71,400 people, of whom 37,400 work for the Bank itself, the Bank Group had consolidated assets at 31 December 2011 of HK$5,607 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 85 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, the Middle East and North Africa, North America and Latin America.

Directors and Secretary

As at the date of this document the Directors 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

Dr Raymond Ch'ien Kuo Fung, GBS, CBE*

Naina L Kidwai

Margaret Leung Ko May Yee

Victor Li Tzar Kuoi*

Dr Lo Ka Shui, GBS*

Zia Mody*

Christopher D Pratt*

Name of Directors

James Riley*

Andreas Sohmen-Pao*

T Brian Stevenson, SBS*

Paul A Thurston

Dr Patrick Wang Shui Chung*

Dr Rosanna Wong Yick-ming, DBE*

Marjorie Yang Mun Tak*

Name of Secretary

Paul A Stafford, ACIS.

* Non-executive Director of the Bank

Principal Subsidiaries

The principal subsidiaries of the Bank 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	RMB10,800 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$751 million A$60 million	Ordinary Preference	100 per cent. 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$1,298 million	Ordinary	100 per cent.	Insurance
HSBC Life (International) Limited [2]	Bermuda	HK$1,278 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$50,000 million divided into 20,000 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$32,140,368,235 comprising 12,856,147,294 ordinary shares of HK$2.50 each. The issued and fully paid up preference share capital was U.S.$11,733,500,000 comprising 2,950,500,000 cumulative redeemable preference shares of U.S.$1.00 each, 6,653,000,000 non-cumulative irredeemable preference shares of U.S.$1.00 each and 2,130,000,000 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 2011 was HK$340,824 million comprising HK$30,190 million of share capital, HK$112,218 million of other reserves, HK$188,416 million of retained profits and HK$10,000 million of proposed fourth interim dividend.

Subordinated liabilities

Subordinated liabilities of the Bank Group, as at 31 December 2010 and 2011, 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.

	2011	**2010**
	HK$m	*HK$m*
Bank Group subordinated liabilities	16,114	21,254

Debt Securities in Issue

The debt securities in issue of the Bank Group as at 31 December 2011 were HK$77,472 million.

SALES AND TRANSFER RESTRICTIONS

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 (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 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 the 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 31 December 2016 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 31 December 2012 or are materially modified from that date 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.

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, if FATCA is implemented as currently proposed by the U.S. Internal Revenue Service (the "**IRS**"), receive less settlement amount than expected.

FATCA is particularly complex and its application is uncertain at this time. The above description is based in part on proposed regulations and official guidance that is subject to change. The application of FATCA to structured products issued after 31 December 2012 (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" 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 IRS to be substantially similar to a payment described in the preceding clauses (i) and (ii). Beginning 1 January 2013, a dividend equivalent payment includes a payment made pursuant to any notional principal contract that falls into one of the seven categories specified by the IRS unless otherwise exempted by the IRS. Where the securities reference an interest in a fixed basket of securities or an index, such fixed basket or index will be treated as a single security. Where the securities reference an interest in a basket of securities or an index that may provide for the payment of dividends from sources within the United States, absent final guidance from the IRS, it is uncertain whether the IRS would determine that payments under the securities are substantially similar to a dividend. If the IRS determines that a payment is substantially similar to a dividend, it may be subject to U.S. withholding tax, unless reduced by an applicable tax treaty. If withholding is so required, we will not be required to pay any additional amounts with respect to amounts so withheld.

TO ENSURE COMPLIANCE WITH U.S. INTERNAL REVENUE SERVICE (IRS) CIRCULAR 230, EACH U.S. TAXPAYER IS HEREBY NOTIFIED THAT: (A) ANY TAX DISCUSSION HEREIN IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED BY THE U.S. TAXPAYER FOR THE PURPOSE OF AVOIDING U.S. FEDERAL INCOME TAX PENALTIES THAT MAY BE IMPOSED ON THE U.S. TAXPAYER; (B) ANY SUCH TAX DISCUSSION WAS WRITTEN TO SUPPORT THE PROMOTION OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED HEREIN; AND (C) THE U.S. TAXPAYER SHOULD SEEK ADVICE BASED ON THE U.S. TAXPAYER'S PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISER.

Are we regulated by any bodies under the rules?

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.

Have we been rated by any credit rating agency?

As at the date of this document, our senior long term debt was rated Aa1 by Moody's Investors Service, Inc. and AA- by Standard and Poor's Ratings Group.

Rating agencies usually receive a fee from the issuers that they rate. The structured products to be issued pursuant to this programme will not be rated.

Are we involved in 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 there been any material adverse change?

There has been no material adverse change in our financial or trading position or prospects or indebtedness since 31 December 2011.

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, KPMG, have given and have not withdrawn their written consent to the inclusion of their report dated 27 February 2012 on the consolidated financial statements of the Issuer as of and for the year ended 31 December 2011, and references thereto and to their name in the form and context in which they appear in this document. The report was not prepared for incorporation in this document. Our auditors do not have any shareholding in our company or 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.

How are dealings in the structured products settled?

Dealings in the structured products on the stock exchange are required to be settled within two trading days from the transaction date and will take place in the relevant Board Lots in Hong Kong dollars. You should refer to the terms and conditions of the relevant structured products for further details.

EXHIBIT A

CONSOLIDATED FINANCIAL STATEMENTS OF THE ISSUER AS AT AND FOR THE YEARS ENDED 31 DECEMBER 2010 AND 31 DECEMBER 2011

The information in this Exhibit A has been extracted from the Annual Report and Accounts 2011 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 2011. The extracts set out in this Exhibit A are not complete and reference should be made to the Annual Report and Accounts 2011 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 set out on pages 27 to 192, which comprise the consolidated and the Bank's balance sheets as at 31 December 2011, 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 2011 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

27 February 2012

Financial Statements

Consolidated income statement for the year ended 31 December 2011

	Note	2011 HK$m	2010 HK$m
Interest income	*4(a)*	**107,458**	85,523
Interest expense	*4(b)*	**(31,786)**	(23,647)
Net interest income		**75,672**	61,876
Fee income		**45,166**	41,657
Fee expense		**(6,871)**	(6,374)
Net fee income	*4(c)*	**38,295**	35,283
Net trading income	*4(d)*	**20,199**	20,716
Net (expense) / income from financial instruments designated at fair value	*4(e)*	**(4,523)**	3,757
Gains less losses from financial investments	*4(f)*	**128**	2,016
Dividend income	*4(g)*	**729**	564
Net earned insurance premiums	*5(b)*	**45,670**	37,193
Other operating income	*4(h)*	**11,389**	10,004
Total operating income		**187,559**	171,409
Net insurance claims incurred and movement in policyholders' liabilities	*5(c)*	**(40,389)**	(39,843)
Net operating income before loan impairment charges and other credit risk provisions		**147,170**	131,566
Loan impairment charges and other credit risk provisions	*4(i)*	**(3,059)**	(4,619)
Net operating income		**144,111**	126,947
Employee compensation and benefits	*6(a)*	**(37,834)**	(32,766)
General and administrative expenses	*4(j)*	**(24,352)**	(22,389)
Depreciation of property, plant and equipment	*26*	**(3,878)**	(3,425)
Amortisation and impairment of intangible assets	*25(c)*	**(1,760)**	(1,664)
Total operating expenses		**(67,824)**	(60,244)
Operating profit		**76,287**	66,703
Share of profit in associates and joint ventures		**15,083**	11,182
Profit before tax		**91,370**	77,885
Tax expense	*7*	**(17,466)**	(14,608)
Profit for the year		**73,904**	63,277
Profit attributable to shareholders		**67,591**	57,597
Profit attributable to non-controlling interests		**6,313**	5,680

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2011

	2011 HK$m	2010 HK$m
Profit for the year	**73,904**	63,277
Other comprehensive income		
Available-for-sale investments:		
– fair value changes taken to equity	**(25,410)**	18,252
– fair value changes transferred to the income statement on disposal	**(231)**	(2,076)
– amounts derecognised on deconsolidation	**–**	(1,849)
– amounts transferred to the income statement on impairment	**(208)**	(24)
– fair value changes transferred to the income statement on hedged items due to hedged risk	**(1,124)**	(500)
– income taxes	**119**	330
Cash flow hedges:		
– fair value changes taken to equity	**303**	654
– fair value changes transferred to the income statement	**(399)**	(1,591)
– income taxes	**15**	155
Property revaluation:		
– fair value changes taken to equity	**12,940**	9,936
– income taxes	**(2,068)**	(1,766)
Share of other comprehensive income of associates and joint ventures	**(1,259)**	(66)
Exchange differences	**(1,235)**	8,881
Actuarial losses on post-employment benefits:		
– before income taxes	**(3,518)**	(807)
– income taxes	**575**	149
Other comprehensive (expense) / income for the year, net of tax	**(21,500)**	29,678
Total comprehensive income for the year, net of tax	**52,404**	92,955
Total comprehensive income for the year attributable to:		
– shareholders	**45,428**	86,473
– non-controlling interests	**6,976**	6,482
	52,404	92,955

Consolidated balance sheet at 31 December 2011

	Note	**2011 HK$m**	2010 HK$m
ASSETS			
Cash and short-term funds	*11*	**919,906**	807,985
Items in the course of collection from other banks		**34,546**	16,878
Placings with banks maturing after one month	*12*	**198,287**	149,557
Certificates of deposit	*13*	**88,691**	73,247
Hong Kong Government certificates of indebtedness	*14*	**162,524**	148,134
Trading assets	*15*	**447,968**	390,208
Financial assets designated at fair value	*16*	**57,670**	54,604
Derivatives	*17*	**377,296**	302,622
Loans and advances to customers	*18*	**2,130,871**	1,891,060
Financial investments	*21*	**722,433**	826,662
Amounts due from Group companies		**152,730**	137,633
Interests in associates and joint ventures	*24*	**91,785**	75,568
Goodwill and intangible assets	*25*	**34,839**	29,690
Property, plant and equipment	*26*	**85,294**	72,347
Deferred tax assets	*7*	**2,325**	2,515
Retirement benefit assets	*6*	**111**	301
Other assets	*28*	**100,204**	60,907
Total assets		**5,607,480**	5,039,918
LIABILITIES			
Hong Kong currency notes in circulation	*14*	**162,524**	148,134
Items in the course of transmission to other banks		**47,163**	26,495
Deposits by banks		**222,582**	167,827
Customer accounts	*29*	**3,565,001**	3,313,244
Trading liabilities	*30*	**171,431**	151,534
Financial liabilities designated at fair value	*31*	**40,392**	40,327
Derivatives	*17*	**383,252**	309,838
Debt securities in issue	*32*	**77,472**	59,283
Retirement benefit liabilities	*6*	**8,097**	4,713
Amounts due to Group companies		**108,423**	83,128
Other liabilities and provisions	*33*	**108,314**	70,946
Liabilities under insurance contracts issued	*34*	**209,438**	177,970
Current tax liabilities	*7*	**4,126**	4,419
Deferred tax liabilities	*7*	**14,712**	11,913
Subordinated liabilities	*36*	**16,114**	21,254
Preference shares	*37*	**97,096**	101,458
Total liabilities		**5,236,137**	4,692,483
EQUITY			
Share capital	*38*	**30,190**	22,494
Other reserves		**112,218**	124,382
Retained profits		**188,416**	161,254
Proposed fourth interim dividend	*9*	**10,000**	12,000
Total shareholders' equity		**340,824**	320,130
Non-controlling interests		**30,519**	27,305
Total equity		**371,343**	347,435
Total equity and liabilities		**5,607,480**	5,039,918

Directors
Stuart T Gulliver
Paul A Thurston
Peter T S Wong

Secretary
Paul A Stafford

Financial Statements (continued)

Consolidated statement of changes in equity for the year ended 31 December 2011

	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 changes in equity for the year ended 31 December 2010

	2010									
			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	148,105	22,983	43,385	848	6,998	15,389	260,202	26,425	286,627
Profit for the year	–	57,597	–	–	–	–	–	57,597	5,680	63,277
Other comprehensive income (net of tax)	–	(766)	7,605	14,168	(742)	8,791	(180)	28,876	802	29,678
Available-for-sale investments	–	–	–	14,095	–	–	–	14,095	38	14,133
Cash flow hedges	–	–	–	–	(743)	–	–	(743)	(39)	(782)
Property revaluation	–	(100)	7,604	–	–	–	–	7,504	666	8,170
Actuarial losses on defined benefit plans	–	(660)	–	–	–	–	–	(660)	2	(658)
Share of other comprehensive income of associates and joint ventures	–	(2)	1	113	–	–	(178)	(66)	–	(66)
Exchange differences	–	(4)	–	(40)	1	8,791	(2)	8,746	135	8,881
Total comprehensive income for the year	–	56,831	7,605	14,168	(742)	8,791	(180)	86,473	6,482	92,955
Dividends paid	–	(26,850)	–	–	–	–	–	(26,850)	(3,899)	(30,749)
Movement in respect of share-based payment arrangements	–	159	–	–	–	–	219	378	36	414
Changes in ownership interest in subsidiaries	–	(88)	–	–	–	–	–	(88)	–	(88)
Changes in non-controlling interests on deconsolidation	–	–	–	–	–	–	–	–	(1,708)	(1,708)
Other movements	–	10	1	4	–	–	–	15	(31)	(16)
Transfers	–	(4,913)	(609)	(4)	–	–	5,526	–	–	–
At 31 December	22,494	173,254	29,980	57,553	106	15,789	20,954	320,130	27,305	347,435

Financial Statements (continued)

Consolidated statement of cash flows for the year ended 31 December 2011

	Note	2011 HK$m	2010 HK$m
Operating activities			
Cash generated from/(used in) operations	42	**16,583**	(107,924)
Interest received on financial investments		**13,269**	12,711
Dividends received on financial investments		**723**	560
Dividends received from associates		**935**	2,768
Taxation paid		**(15,790)**	(13,269)
Net cash inflow/(outflow) from operating activities		**15,720**	(105,154)
Investing activities			
Purchase of financial investments		**(495,823)**	(475,669)
Proceeds from sale or redemption of financial investments		**588,409**	548,115
Purchase of property, plant and equipment		**(2,870)**	(6,165)
Proceeds from sale of property, plant and equipment and assets held for sale		**215**	63
Purchase of other intangible assets		**(1,804)**	(1,373)
Net cash outflow in respect of the acquisition of and increased shareholding in subsidiaries	43	**(143)**	(127)
Net cash inflow/(outflow) in respect of the sale of subsidiaries	43	**1**	(13)
Net cash outflow in respect of the purchase of interests in associates and joint ventures		**(263)**	(10,676)
Net cash inflow from the sale of interests in business portfolios	43	**5,649**	–
Proceeds from the sale of interests in associates		**19**	136
Net cash inflow from investing activities		**93,390**	54,291
Net cash inflow/(outflow) before financing		**109,110**	(50,863)
Financing			
Issue of ordinary share capital		**7,696**	–
Redemption of preference shares		**(4,280)**	–
Change in non-controlling interests		**–**	(24)
Repayment of subordinated liabilities		**(5,152)**	(2,055)
Issue of subordinated liabilities		**3,502**	1,533
Ordinary dividends paid	9	**(33,000)**	(26,850)
Dividends paid to non-controlling interests		**(3,764)**	(3,899)
Interest paid on preference shares		**(2,421)**	(3,118)
Interest paid on subordinated liabilities		**(793)**	(582)
Net cash outflow from financing		**(38,212)**	(34,995)
Increase/(decrease) in cash and cash equivalents	43	**70,898**	(85,858)

Bank balance sheet at 31 December 2011

	Note	2011 HK$m	2010 HK$m
ASSETS			
Cash and short-term funds	11	**612,265**	551,003
Items in the course of collection from other banks		**29,821**	12,143
Placings with banks maturing after one month	12	**108,873**	74,791
Certificates of deposit	13	**23,987**	27,888
Hong Kong Government certificates of indebtedness	14	**162,524**	148,134
Trading assets	15	**317,321**	297,929
Financial assets designated at fair value	16	**2,283**	2,086
Derivatives	17	**370,678**	295,479
Advances to customers	18	**1,176,602**	1,016,312
Financial investments	21	**362,307**	503,752
Amounts due from group companies		**248,001**	198,322
Investments in subsidiaries	23	**57,724**	52,924
Interests in associates and joint ventures	24	**28,139**	28,139
Goodwill and intangible assets	25	**4,831**	4,713
Property, plant and equipment	26	**51,876**	45,061
Deferred tax assets	7	**1,098**	1,104
Retirement benefit assets	6	**73**	179
Other assets	28	**56,938**	31,873
Total assets		**3,615,341**	3,291,832
LIABILITIES			
Hong Kong currency notes in circulation	14	**162,524**	148,134
Items in the course of transmission to other banks		**38,577**	17,951
Deposits by banks		**158,746**	130,476
Customer accounts	29	**2,220,072**	2,044,664
Trading liabilities	30	**78,959**	91,184
Financial liabilities designated at fair value	31	**5,910**	6,581
Derivatives	17	**377,165**	303,882
Debt securities in issue	32	**46,360**	43,139
Retirement benefit liabilities	6	**4,150**	2,465
Amounts due to group companies		**152,906**	145,894
Other liabilities and provisions	33	**71,585**	44,032
Current tax liabilities	7	**2,748**	2,686
Deferred tax liabilities	7	**5,884**	5,525
Subordinated liabilities	36	**9,386**	9,404
Preference shares	37	**96,969**	101,306
Total liabilities		**3,431,941**	3,097,323
EQUITY			
Share capital	38	**30,190**	22,494
Other reserves		**49,278**	71,929
Retained profits		**93,932**	88,086
Proposed fourth interim dividend	9	**10,000**	12,000
Total equity		**183,400**	194,509
Total equity and liabilities		**3,615,341**	3,291,832

Directors
Stuart T Gulliver
Paul A Thurston
Peter T S Wong

Secretary
Paul A Stafford

Financial Statements (continued)

Bank statement of changes in equity for the year ended 31 December 2011

	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 2011	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	–	(33,000)	–	–	–	–	–	(33,000)
Movement in respect of share-based payment	–	52	–	–	–	–	551	603
Other movements	–	(4)	–	–	–	–	(60)	(64)
Transfers	–	519	(519)	–	–	–	–	–
At 31 December 2011	30,190	103,932	24,296	26,013	63	(3,152)	2,058	183,400

Bank statement of changes in equity for the year ended 31 December 2010

	2010							
			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 2010	22,494	88,837	13,595	39,050	763	(1,313)	1,485	164,911
Profit for the year	–	38,227	–	–	–	–	–	38,227
Other comprehensive income (net of tax)	–	(671)	5,191	11,499	(693)	2,617	–	17,943
Available-for-sale investments	–	–	–	11,539	–	–	–	11,539
Cash flow hedges	–	–	–	–	(694)	–	–	(694)
Property revaluation	–	(53)	5,191	–	–	–	–	5,138
Actuarial losses on defined benefit plans	–	(624)	–	–	–	–	–	(624)
Exchange differences	–	6	–	(40)	1	2,617	–	2,584
Total comprehensive income	–	37,556	5,191	11,499	(693)	2,617	–	56,170
Dividends	–	(26,850)	–	–	–	–	–	(26,850)
Movement in respect of share-based payment	–	112	–	–	–	–	82	194
Other movements	–	82	–	2	–	–	–	84
Transfers	–	349	(349)	–	–	–	–	–
At 31 December 2010	22,494	100,086	18,437	50,551	70	1,304	1,567	194,509

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 2011.

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 and premises.

During 2011 the group adopted a number of interpretations and amendments to standards which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of the Bank.

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 2011.

c **Future Accounting Developments**

At 31 December 2011, 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 2011.

Standards applicable in 2012

In December 2010, the HKICPA issued an amendment to HKAS 'Income Taxes', whereby deferred taxes on investment property, carried under the fair value model in HKAS 40, will be measured on the presumption that an investment property is recovered entirely through sale. The presumption is rebutted if the investment property is held within a business whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The amendment will be effective for annual periods beginning on or after 1 January 2012. The group does not expect adoption of the amendment to HKAS 12 to have a significant effect on the group's consolidated financial statements.

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'). The standards are effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. 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 initial assessment, we do not expect HKFRS 11 to have a material effect on the group's financial statements. The group is currently assessing the impact of HKFRS 10 and it is not practical to quantify the effect as at the date of publication of these financial statements.

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.

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.

The group is currently assessing HKFRS 13 and it is not practical to quantify the effect as at the date of publication of these financial statements.

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 must 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 2011 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 expected to be material. The effect at the date of adoption will depend on market interest rates, rates of return and the actual mix of scheme assets at that time.

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.

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 additions to HKFRS 9 relating to financial liabilities. Together, these changes represent the first phase in the planned replacement of HKAS 39 'Financial Instruments: Recognition and Measurement' ('HKAS 39') with a new standard for financial instruments.

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 with early adoption permitted. HKFRS 9 is required to be applied retrospectively but prior periods need not be restated.

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. The HKAS 39 replacement project has not yet been completed. The group remains unable to provide a date by which it plans to apply HKFRS 9 and it remains impracticable to quantify the impact of HKFRS 9 as at the date of publication of these consolidated financial statements.

Notes on the Financial Statements (continued)

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 first, whether there are indications that an impairment loss may have already been incurred, and then estimating the amount and timing of expected cash flows, which form the basis of the impairment loss that is recorded.

For collectively assessed loans, 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.

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.

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

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

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

A change in the fair value of a financial asset which is classified as 'available-for sale' is recorded directly in equity 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 available-for-sale financial investments

Judgment is required in determining whether or not a decline in fair value of an available-for-sale financial investment below its original cost is of such a nature as to constitute impairment, and thus whether an impairment loss needs to be recognised under HKAS 39 'Financial Instruments: Recognition and Measurement' (HKAS 39).

Liabilities under investment contracts

Estimating the liabilities for long-term investment contracts where the group has guaranteed a minimum return involves the use of statistical techniques. The selection of these techniques and the assumptions used about future interest rates and rates of return on equity, as well as behavioural and other future events, have a significant impact on the amount recognised as a liability.

Insurance contracts

Classification

HKFRS 4 'Insurance Contracts' (HKFRS 4) requires the group to determine whether an insurance contract that transfers both insurance risk and financial risk is classified as an insurance contract, or as a financial instrument under HKAS 39, or whether the insurance and non-insurance elements of the contract should be accounted for separately. This process involves 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.

Notes on the Financial Statements (continued)

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.

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 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 impairment losses. 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.

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.

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d *Loan impairment*

Losses for impaired loans are promptly recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are 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 and are for larger amounts, which 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;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency.

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.

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 utilises 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. 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.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

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 loss. 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.

Notes on the Financial Statements (continued)

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.

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 provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included within 'Other operating income' in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised as a gain in 'Other operating income' in the income statement, 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. These renegotiated loans are segregated from other parts of the loan portfolio for the purposes of collective impairment assessment, to reflect their risk profile.

Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due.

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). Such financial assets or financial liabilities are recognised initially at fair value, with transaction costs taken to the income statement, and are subsequently remeasured at fair value. All subsequent gains and losses from changes in the fair value of these assets and liabilities, together with related interest income and expense and dividends, are recognised in the income statement within 'Net trading income' as they arise.

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f *Financial instruments designated at fair value*

A financial instrument, other than one held for trading, is classified in this category if it meets the criteria set out below, and is so designated by management. 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 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). Financial assets and financial liabilities so designated are recognised initially at fair value., with transaction costs taken directly to the income statement, and are subsequently re-measured at fair value. Subsequently, the fair values are re-measured, and gains and losses from changes in the fair value therein are recognised in the income statement within 'Net income from financial instruments designated at fair value'.

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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, 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 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.

3 Summary of significant accounting policies *(continued)*

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'.

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'.

3 Summary of significant accounting policies *(continued)*

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.

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’.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

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'.

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.

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.

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.

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 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.

(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).

Notes on the Financial Statements (continued)

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; and
- leasehold land is depreciated over the unexpired terms of the leases;
- buildings and improvements thereto are depreciated at the greater of 2% per annum on the straight line basis or over the unexpired terms of the leases or over the remaining useful lives of the buildings.

(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.

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 '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. 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 utilised.

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 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.

Notes on the Financial Statements (continued)

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.

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.

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 and presentation 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 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.

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u *Provisions*

Provisions for liabilities and charges are recognised when it is probable that an outflow of economic benefits will be required to settle a present legal or constructive obligation arising from past events and a reliable estimate can be made of the amount of the obligation.

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.

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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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

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:

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 on a payable basis.

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 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 discretionary participating features, 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.

3 Summary of significant accounting policies *(continued)*

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.

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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'.

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y *Dividends*

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

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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'.

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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.

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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.

Notes on the Financial Statements (continued)

4 Operating profit

The operating profit for the year is stated after taking account of:

a *Interest income*

	2011 HK$m	2010 HK$m
Interest income on listed securities	**8,004**	8,012
Interest income on unlisted securities	**17,989**	15,878
Other interest income	**89,699**	69,053
	115,692	92,943
Less: interest income classified as 'Net trading income' (note 4(d))	**(8,183)**	(7,366)
Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 4(e))	**(51)**	(54)
	107,458	85,523

Included in the above is interest income accrued on impaired financial assets of HK$308m (2010: HK$465m), including unwinding of discounts on loan impairment losses of HK$294m (2010: HK$324m).

b *Interest expense*

	2011 HK$m	2010 HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**831**	704
Interest expense on preference shares	**2,337**	2,659
Other interest expense	**32,867**	22,908
	36,035	26,271
Less: interest expense classified as 'Net trading income' (note 4(d))	**(4,225)**	(2,599)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4(e))	**(24)**	(25)
	31,786	23,647

c *Net fee income*

	2011 HK$m	2010 HK$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	**15,081**	13,172
– fee expense	**(1,415)**	(1,404)
	13,666	11,768
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**8,862**	8,717
– fee expense	**(1,213)**	(1,005)
	7,649	7,712

4 Operating profit *(continued)*

d *Net trading income*

	2011 HK$m	2010 HK$m
Dealing profits	**15,590**	15,484
– Foreign exchange	**15,313**	13,036
– Interest rate derivatives	**400**	978
– Debt securities	**1,300**	672
– Equities and other trading	**(1,423)**	798
Loss from hedging activities	**(71)**	(11)
Fair value hedges		
– Net gain on hedged items attributable to the hedged risk	**1,050**	563
– Net loss on hedging instruments	**(1,147)**	(579)
– Other	**26**	–
Cash flow hedges		
– Net hedging gain	**–**	5
Interest on trading assets and liabilities	**3,958**	4,767
– Interest income (note 4(a))	**8,183**	7,366
– Interest expense (note 4(b))	**(4,225)**	(2,599)
Dividend income from trading securities	**722**	476
– Listed investments	**608**	391
– Unlisted investments	**114**	85
	20,199	20,716

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

	2011 HK$m	2010 HK$m
(Expense)/income on assets designated at fair value which back insurance and investment contracts	**(4,542)**	4,509
Change in fair value of liabilities to customers under investment contracts	**30**	(1,217)
	(4,512)	3,292
Net change in fair value of other financial assets/liabilities designated at fair value[1]	**(38)**	436
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	**51**	54
– Interest expense (note 4(b))	**(24)**	(25)
	(4,523)	3,757

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 2011 the group recognised a HK$15m gain on changes in the fair value of these instruments arising from changes in own credit risk (2010:HK$51m loss).*

f *Gains less losses from financial investments*

	2011 HK$m	2010 HK$m
Gains on disposal of available-for-sale securities	**470**	2,365
Impairment of available-for-sale equity investments	**(342)**	(349)
	128	2,016

There are no gains or losses on the disposal of held-to-maturity investments in the year (2010: nil).

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

g *Dividend income*

	2011 HK$m	2010 HK$m
Listed investments	**431**	418
Unlisted investments	**298**	146
	729	564

h *Other operating income*

	2011 HK$m	2010 HK$m
Rental income from investment properties	**191**	170
Movement in present value of in-force insurance business	**5,524**	4,106
Gains on investment properties	**1,033**	483
(Loss)/gain on disposal of property, plant and equipment, and assets held for sale	**(3)**	13
(Loss)/gain on disposal of subsidiaries, associates and business portfolios	**(9)**	603
Surplus arising on property revaluation	**8**	102
Other	**4,645**	4,527
	11,389	10,004

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$558m (2010: HK$1,049m). There are no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2010: nil).

i *Loan impairment charges and other credit risk provisions*

	2011 HK$m	2010 HK$m
Net charge for impairment of loans and advances to customers		
– Individually assessed impairment allowances:		
New allowances	**2,254**	3,605
Releases	**(1,204)**	(1,069)
Recoveries	**(356)**	(322)
	694	2,214
– Net charge for collectively assessed impairment allowances	**2,401**	2,474
Net charge for other credit risk provisions	**(36)**	(69)
Net charge for loan impairment and other credit risk provisions	**3,059**	4,619

Included in the net charge for other credit risk provisions is an impairment release of HK$4m against available-for-sale debt securities (2010: impairment release of HK$38m). There are no impairment losses or provisions relating to held-to-maturity investments (2010: nil).

4 Operating profit *(continued)*

j *General and administrative expenses*

	2011 HK$m	2010 HK$m
Premises and equipment		
– Rental expenses	**3,102**	2,749
– Amortisation of prepaid operating lease payments	**18**	18
– Other premises and equipment	**3,810**	3,496
	6,930	6,263
Marketing and advertising expenses	**3,969**	3,891
Other administrative expenses	**13,453**	12,235
	24,352	22,389

Included in operating expenses are direct operating expenses of HK$19m (2010: HK$20m) 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$2m (2010: HK$2m).

Included in operating expenses are minimum lease payments under operating leases of HK$3,170m (2010: HK$2,934m).

k *Auditors' remuneration*

Auditors' remuneration amounted to HK$77m (2010: HK$76m), of which HK$29m (2010: HK$29m) related to the Bank.

Notes on the Financial Statements (continued)

5 Insurance income

Included in the consolidated income statement are the following revenues earned by the insurance business:

a *Insurance income*

	2011 HK$m	2010 HK$m
Net interest income	**6,779**	5,832
Net fee income	**692**	1,070
Net trading loss	**(386)**	(5)
Net income from financial instruments designated at fair value	**(4,460)**	3,371
Gains less losses from financial investments	**(1)**	386
Dividend income	**1**	–
Net earned insurance premiums (note 5(b))	**45,670**	37,193
Movement in present value of in-force business	**5,524**	4,106
Other operating income	**237**	70
	54,056	52,023
Net insurance claims incurred and movement in policyholders' liabilities (note 5(c))	**(40,389)**	(39,843)
Net operating income	**13,667**	12,180

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
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**
2010					
Gross written premiums	3,166	30,729	4,224	–	38,119
Movement in unearned premiums	(235)	–	–	–	(235)
Gross earned premiums	2,931	30,729	4,224	–	37,884
Gross written premiums ceded to reinsurers	(457)	(267)	(8)	–	(732)
Reinsurers' share of movement in unearned premiums	41	–	–	–	41
Reinsurers' share of gross earned premiums	(416)	(267)	(8)	–	(691)
Net earned premiums	2,515	30,462	4,216	–	37,193

5 Insurance income *(continued)*

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

	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
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 policyholders' liabilities	**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 policyholders' liabilities	**(161)**	**(183)**	**(802)**	**–**	**(1,146)**
Net insurance claims incurred and movement in policyholders' liabilities	**1,226**	**36,814**	**2,348**	**1**	**40,389**
2010					
Claims, benefits and surrenders paid	1,290	4,030	2,330	122	7,772
Movement in provision	(14)	28,866	2,672	(119)	31,405
Gross claims incurred and movement in policyholders' liabilities	1,276	32,896	5,002	3	39,177
Reinsurers' share of claims, benefits and surrenders paid	(160)	(157)	(298)	–	(615)
Reinsurers' share of movement in provision	20	3	1,258	–	1,281
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(140)	(154)	960	–	666
Net insurance claims incurred and movement in policyholders' liabilities	1,136	32,742	5,962	3	39,843

Notes on the Financial Statements (continued)

6 Employee compensation and benefits

a *Employee compensation and benefits*

	2011 **HK$m**	2010 HK$m
Wages and salaries	**35,020**	30,412
Social security costs	**912**	736
Retirement benefit costs		
– Defined contribution plans	**1,043**	920
– Defined benefit plans (note 6(v))	**859**	698
	37,834	32,766

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$71m (2010: HK$117m). This comprises fees of HK$6m (2010: HK$7m) and other emoluments of HK$66m (2010: HK$110m) which includes pension benefits of HK$1m (2010: HK$6m).

c *Retirement benefit pension plans*

The group operates 80 (2010: 77) retirement benefit plans, with a total cost of HK$1,902m (2010: HK$1,618m), of which HK$587m (2010: HK$649m) relates to overseas plans and HK$30m (2010: HK$28m) are 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 35% (2010: 37%) 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$804m (2010: HK$628m) 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:

	2011 **% p.a.**	2010 % p.a.
Discount rate	**1.47**	2.85
Expected rates of return on plan assets[1]		
– equities	**7.5**	8.8
– bonds	**3.9**	3.8
– other	**3.9**	5.1
Rate of pay increase		
– long term	**5.0**	5.0
Mortality table	**HKLT2001**[2]	HKLT2001[2]

1 *The expected rates of return are weighted on the basis of the fair value of the plan assets.*
2 *HKLT2001 – Hong Kong Life Tables 2001.*

The overall expected long-term rate of return on assets as at 31 December 2011 was 4.7% (2010: 4.9%). 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.

6 Employee compensation and benefits *(continued)*

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 103% 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 108% 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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Equities	**3,162**	3,144	**1,483**	1,416
Bonds	**9,357**	9,626	**6,600**	6,625
Other	**1,594**	2,117	**1,269**	1,818
Fair value of plan assets	**14,113**	14,887	**9,352**	9,859
Present value of funded obligations	**21,699**	19,021	**13,186**	11,958
Present value of unfunded obligations	**402**	287	**247**	198
Defined benefit obligations	**22,101**	19,308	**13,433**	12,156
Past service cost not recognised	**3**	10	**5**	12
Effect of limit on plan surpluses	**1**	1	**1**	1
Net defined benefit liability	**(7,986)**	(4,412)	**(4,077)**	(2,286)
Reported as 'Assets'	**111**	301	**73**	179
Reported as 'Liabilities'	**(8,097)**	(4,713)	**(4,150)**	(2,465)
Net defined benefit liability	**(7,986)**	(4,412)	**(4,077)**	(2,286)

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

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**19,308**	17,948	**12,156**	11,437
Current service cost	**1,024**	979	**658**	626
Interest cost	**591**	508	**390**	334
Contributions by employees	**2**	2	**–**	–
Actuarial losses	**2,641**	808	**1,263**	712
Benefits paid	**(1,203)**	(1,104)	**(848)**	(704)
Past service cost – vested immediately	**28**	56	**27**	47
Past service cost – unvested benefits	**–**	12	**–**	15
Liabilities extinguished on settlements	**(195)**	–	**(128)**	–
Exchange and other movements	**(95)**	99	**(85)**	(311)
At 31 December	**22,101**	19,308	**13,433**	12,156

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

(iv) Changes in the fair value of plan assets

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**14,887**	14,318	**9,859**	9,627
Expected return	**754**	847	**510**	587
Contributions by the group/the Bank	**718**	705	**436**	479
Contributions by employees	**2**	2	**–**	–
Actuarial (losses)/gains	**(880)**	2	**(471)**	(59)
Benefits paid	**(1,140)**	(1,052)	**(808)**	(672)
Assets distributed on settlement	**(153)**	–	**(101)**	–
Exchange and other movements	**(75)**	65	**(73)**	(103)
At 31 December	**14,113**	14,887	**9,352**	9,859

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

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Equities	**341**	427	**284**	366
Others	**179**	92	**132**	50
	520	519	**416**	416

The group's actual loss on plan assets for the year ended 31 December 2011 was HK$157m (2010: HK$849m gain). The Bank's actual gain on plan assets for the year ended 31 December 2011 was HK$8m (2010: HK$528m gain).

The group expects to make HK$941m of contributions to defined benefit pension plans during 2012. Contributions to be made by the Bank are expected to be HK$480m.

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

	2011	2010
	HK$m	HK$m
Current service cost	**1,024**	979
Interest cost	**591**	508
Expected return on plan assets	**(754)**	(847)
Past service costs	**37**	58
Gains on settlements	**(39)**	–
Total net expense	**859**	698

The total net actuarial loss recognised in total equity during 2011 in respect of defined benefit pension plans was HK$3,518m (2010: HK$807m). After deduction of non-controlling interests, a loss of HK$2,912m (2010: HK$810m) was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date are HK$10,298m (2010: HK$6,779m). After deduction of non-controlling interests, the total net actuarial losses recognised in total shareholders' equity to date are HK$8,829m (2010: HK$5,917m).

The total net actuarial loss recognised in the Bank's retained profits during 2011 in respect of defined benefit pension plans was HK$1,727m (2010: HK$772m). Total net actuarial losses recognised outside of the income statement to date are HK$5,988m (2010: HK$4,261m).

The total effect of the limit on plan surpluses recognised within actuarial losses in equity for both the group and the Bank during 2011 was nil (2010: HK$1m).

6 Employee compensation and benefits *(continued)*

(vi) Defined benefit schemes sponsored by the Bank's immediate holding company

Expenses recognised in the income statement in respect of defined benefit schemes sponsored by the Bank's immediate holding company, HSBC Asia Holdings BV ("HABV"), were not included in the tables above as these are reported as Defined Contribution Plans.

HABV recharges contributions to participating members of the HSBC International Staff Retirement Benefits Scheme, a funded defined benefit scheme, in accordance with schedules determined by the Trustees following consultation with qualified actuaries. There is no contractual agreement or stated policy for charging the net defined benefit cost to the group.

The scheme is denominated in Sterling with the following details:

	2011	2010
	% p.a.	% p.a.
Assumptions as at 31 December		
Inflation	**3.40**	3.70
Salary increases	**1.75**	5.45
Pension increases	**3.40**	3.70
Discount rate	**5.10**	5.40
Expected return on assets	**3.93**	5.51
Mortality table	**S1PM/FA_ LYOB** [1]	PNA00YOB

1 *The 'S1PM/FA_ Light Year of Birth' tables are based on the series of tables for self-administered pension schemes (SAPS) prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries. The mortality rates (that is, the probability of death in a given year) in these tables have been reduced by 20% for males and 15% for females. An allowance for future improvements in mortality has been made in line with those underlying the medium cohort improvements applicable to the series, subject to a minimum improvement of 1% per annum.*

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

The International Staff Scheme

	2011 £m	2010 £m
Funded status at 31 December		
Plan assets	**842**	686
Defined benefit obligations	**(687)**	(737)
Net defined benefit asset/(liability)	**155**	(51)
Categories of assets at 31 December		
Bonds	**420**	520
Property	**34**	33
Other	**388**	133
Fair value of plan assets	**842**	686
Reconciliation of defined benefit obligations at 31 December		
At 1 January	**737**	693
Current service cost	**14**	14
Interest cost	**39**	39
Contributions by employees	**1**	1
Actuarial (gains) / losses	**(73)**	19
Benefits paid	**(31)**	(29)
At 31 December	**687**	737
Reconciliation of the fair value of plan assets at 31 December		
At 1 January	**686**	604
Expected return	**37**	33
Actuarial gains	**138**	66
Contributions by the group	**11**	11
Contributions by employees	**1**	1
Benefits paid	**(31)**	(29)
At 31 December	**842**	686
Estimated contributions in the following year		
Estimated company contributions in the financial year	**9**	11
Estimated employee contributions in the financial year	**1**	1
Estimated total contributions in the financial year	**10**	12

(vii) Amounts for the current and previous years

	The group					The Bank				
	2011 HK$m	2010 HK$m	2009 HK$m	2008 HK$m	2007 HK$m	**2011 HK$m**	2010 HK$m	2009 HK$m	2008 HK$m	2007 HK$m
Defined benefit obligations	**22,101**	19,308	17,948	20,954	17,966	**13,433**	12,156	11,437	12,841	11,310
Plan assets	**14,113**	14,887	14,318	13,588	16,572	**9,353**	9,859	9,627	9,379	10,506
Net deficit	**(7,988)**	(4,421)	(3,630)	(7,366)	(1,394)	**(4,080)**	(2,297)	(1,810)	(3,462)	(804)
Experience (losses)/gains on plan liabilities	**(344)**	(214)	408	(132)	(790)	**(230)**	(175)	60	(363)	(585)
Experience (losses)/gains on plan assets	**(911)**	2	368	(3,591)	948	**(502)**	(59)	(47)	(1,400)	487

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% (2010: 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 2011. 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:

	2011 HK$m	2010 HK$m
Current income tax		
– Hong Kong profits tax – on current year profit	**6,395**	6,378
– Hong Kong profits tax – adjustments in respect of prior years	**145**	93
– Overseas taxation – on current year profit	**9,593**	7,470
– Overseas taxation – adjustments in respect of prior years	**(219)**	117
	15,914	14,058
Deferred tax		
– Origination and reversal of temporary differences	**1,502**	710
– Adjustments in respect of prior years	**50**	(160)
	1,552	550
	17,466	14,608

Notes on the Financial Statements (continued)

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	Others HK$m	Total HK$m
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**
2010						
At 1 January	1,100	–	1,460	(447)	555	2,668
Exchange and other adjustments	85	–	40	(372)	(5)	(252)
Credit/(charge) to income statement	484	–	(604)	(9)	38	(91)
(Charge)/credit to reserves	–	–	–	(24)	214	190
At 31 December	1,669	–	896	(852)	802	2,515

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	Others HK$m	Total HK$m
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**
2010						
At 1 January	414	–	1,246	(452)	228	1,436
Exchange and other adjustments	115	–	42	(323)	47	(119)
Credit/(charge) to income statement	87	–	(442)	(9)	(36)	(400)
(Charge)/credit to reserves	–	–	–	(13)	200	187
At 31 December	616	–	846	(797)	439	1,104

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	Others HK$m	Total HK$m
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**
2010						
At 1 January	2,059	(32)	(373)	6,085	2,764	10,503
Exchange and other adjustments	1,926	–	(12)	(315)	(1,915)	(316)
Charge/(credit) to income statement	693	1	90	(14)	(311)	459
Charge/(credit) to reserves	2	–	–	1,700	(435)	1,267
At 31 December	4,680	(31)	(295)	7,456	103	11,913

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	Others HK$m	Total HK$m
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**
2010						
At 1 January	1,790	(32)	(232)	3,343	542	5,411
Exchange and other adjustments	(495)	–	–	(263)	641	(117)
(Credit)/charge to income statement	(171)	1	21	(39)	(323)	(511)
Charge/(credit) to reserves	–	–	–	1,189	(447)	742
At 31 December	1,124	(31)	(211)	4,230	413	5,525

Notes on the Financial Statements (continued)

7 Tax expense *(continued)*

(iii) Net deferred tax liabilities

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Deferred tax liabilities recognised on the balance sheet	**14,712**	11,913	**5,884**	5,525
Deferred tax assets recognised on the balance sheet	**(2,325)**	(2,515)	**(1,098)**	(1,104)
	12,387	9,398	**4,786**	4,421

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK$3,777m (2010: HK$3,390m). Of this amount, HK$2,062m (2010: HK$1,809m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK$1,164m (2010: HK$617m) 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 is not contemplated, 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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong profits tax	**658**	981	**251**	366
Overseas taxation	**3,468**	3,438	**2,497**	2,320
Current tax liabilities	**4,126**	4,419	**2,748**	2,686
Deferred tax liabilities	**14,712**	11,913	**5,884**	5,525
	18,838	16,332	**8,632**	8,211

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

	2011	2010
	HK$m	HK$m
Profit before tax	**91,370**	77,885
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**17,082**	14,880
Tax effect of non-taxable revenue (net of non-deductible expenses)	**(726)**	(792)
Tax effect of unused tax losses not recognised	**246**	(94)
Under / (over) provision in prior years	**(24)**	50
Others	**888**	564
	17,466	14,608

8 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$37,812m (2010: HK$38,227m) which has been dealt with in the accounts of the Bank.

9 Dividends

	2011		2010	
	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	**1.33**	**12,000**	0.98	8,850
– first interim dividend paid	**0.78**	**7,000**	0.67	6,000
– second interim dividend paid	**0.78**	**7,000**	0.67	6,000
– third interim dividend paid	**0.68**	**7,000**	0.67	6,000
	3.57	**33,000**	2.99	26,850

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2011 of HK$10,000m (HK$0.83 per ordinary share).

Notes on the Financial Statements (continued)

10 Analysis of financial assets and liabilities by measurement basis

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 group

	At 31 December 2010								
	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	–	–	–	447,524	279,080	81,381	–	–	807,985
Items in the course of collection from other banks	–	–	–	–	–	16,878	–	–	16,878
Placings with banks maturing after one month	–	–	–	149,557	–	–	–	–	149,557
Certificates of deposit	–	–	6,290	–	66,957	–	–	–	73,247
Hong Kong Government certificates of indebtedness	–	–	–	–	–	148,134	–	–	148,134
Trading assets	390,208	–	–	–	–	–	–	–	390,208
Financial assets designated at fair value	–	54,604	–	–	–	–	–	–	54,604
Derivatives	301,304	–	–	–	–	–	422	896	302,622
Loans and advances to customers	–	–	–	1,891,060	–	–	–	–	1,891,060
Financial investments	–	–	121,743	–	704,919	–	–	–	826,662
Amounts due from Group companies	40,397	5,453	–	–	–	91,783	–	–	137,633
Other assets	–	–	–	–	–	56,452	–	–	56,452
Total financial assets	731,909	60,057	128,033	2,488,141	1,050,956	394,628	422	896	4,855,042
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	148,134	–	–	148,134
Items in the course of transmission to other banks	–	–	–	–	–	26,495	–	–	26,495
Deposits by banks	–	–	–	–	–	167,827	–	–	167,827
Customer accounts	–	–	–	–	–	3,313,244	–	–	3,313,244
Trading liabilities	151,534	–	–	–	–	–	–	–	151,534
Financial liabilities designated at fair value	–	40,327	–	–	–	–	–	–	40,327
Derivatives	307,225	–	–	–	–	–	2,488	125	309,838
Debt securities in issue	–	–	–	–	–	59,283	–	–	59,283
Amounts due to Group companies	25,163	3	–	–	–	57,962	–	–	83,128
Other liabilities	–	–	–	–	–	65,737	–	–	65,737
Subordinated liabilities	–	–	–	–	–	21,254	–	–	21,254
Preference shares	–	–	–	–	–	101,458	–	–	101,458
Total financial liabilities	483,922	40,330	–	–	–	3,961,394	2,488	125	4,488,259

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

10 Analysis of financial assets and liabilities by measurement basis *(continued)*

The Bank

	At 31 December 2010								
	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	–	–	–	244,121	252,727	54,155	–	–	551,003
Items in the course of collection from other banks	–	–	–	–	–	12,143	–	–	12,143
Placings with banks maturing after one month	–	–	–	74,791	–	–	–	–	74,791
Certificates of deposit	–	–	–	–	27,888	–	–	–	27,888
Hong Kong Government certificates of indebtedness	–	–	–	–	–	148,134	–	–	148,134
Trading assets	297,929	–	–	–	–	–	–	–	297,929
Financial assets designated at fair value	–	2,086	–	–	–	–	–	–	2,086
Derivatives	294,739	–	–	–	–	–	122	618	295,479
Loans and advances to customers	–	–	–	1,016,312	–	–	–	–	1,016,312
Financial investments	–	–	–	–	503,752	–	–	–	503,752
Amounts due from Group companies	43,340	–	–	–	–	154,982	–	–	198,322
Other assets	–	–	–	–	–	28,980	–	–	28,980
Total financial assets	636,008	2,086	–	1,335,224	784,367	398,394	122	618	3,156,819
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	148,134	–	–	148,134
Items in the course of transmission to other banks	–	–	–	–	–	17,951	–	–	17,951
Deposits by banks	–	–	–	–	–	130,476	–	–	130,476
Customer accounts	–	–	–	–	–	2,044,664	–	–	2,044,664
Trading liabilities	91,184	–	–	–	–	–	–	–	91,184
Financial liabilities designated at fair value	–	6,581	–	–	–	–	–	–	6,581
Derivatives	302,365	–	–	–	–	–	1,474	43	303,882
Debt securities in issue	–	–	–	–	–	43,139	–	–	43,139
Amounts due to Group companies	15,529	–	–	–	–	130,365	–	–	145,894
Other liabilities	–	–	–	–	–	40,712	–	–	40,712
Subordinated liabilities	–	–	–	–	–	9,404	–	–	9,404
Preference shares	–	–	–	–	–	101,306	–	–	101,306
Total financial liabilities	409,078	6,581	–	–	–	2,666,151	1,474	43	3,083,327

Notes on the Financial Statements (continued)

11 Cash and short-term funds

	The group		The Bank	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Cash in hand	**15,204**	13,001	**7,888**	7,086
Sight balances with central banks	**94,903**	68,380	**72,022**	47,069
Placings with banks with remaining maturity of one month or less	**456,294**	447,524	**232,654**	244,121
Treasury bills and other eligible bills	**353,505**	279,080	**299,701**	252,727
	919,906	807,985	**612,265**	551,003

As at 31 December 2011, included within notes 11 and 12, the total amount placed with central banks by the group, including sight balances, amounted to HK$350,823m (2010: HK$232,779m). Placings with central banks made by the Bank amounted to HK$211,307m (2010: HK$135,453m).

Treasury bills and other eligible bills are analysed as follows:

	The group		The Bank	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Treasury bills and other eligible bills – available-for-sale				
– subject to repledge or resale by counterparties	**498**	–	**498**	–
– not subject to repledge or resale by counterparties	**353,007**	279,080	**299,203**	252,727
	353,505	279,080	**299,701**	252,727

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	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Gross placings with banks maturing after one month but not more than one year	**173,498**	142,313	**93,098**	70,731
Gross placings with banks maturing after one year	**24,789**	7,244	**15,775**	4,060
Total placings with banks	**198,287**	149,557	**108,873**	74,791

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	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Held-to-maturity	**8,342**	6,290	**–**	–
Available-for-sale	**80,349**	66,957	**23,987**	27,888
	88,691	73,247	**23,987**	27,888

Certificates of deposit held are largely unlisted. There were no disposals of held-to-maturity certificates of deposit during the year (2010: 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.

15 Trading assets

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**168,849**	200,379	**120,575**	155,174
Equity shares	**15,060**	17,798	**14,978**	17,620
Treasury bills and other eligible bills	**230,959**	140,873	**160,911**	112,602
Other	**33,100**	31,158	**20,857**	12,533
	447,968	390,208	**317,321**	297,929
Trading assets				
– which may be repledged or resold by counterparties	**281**	5,619	**281**	5,619
– not subject to repledge or resale by counterparties	**447,687**	384,589	**317,040**	292,310
	447,968	390,208	**317,321**	297,929

The amount of listed treasury bills and other eligible bills amounted to HK$4,427m at both group and Bank level as at 31 December 2011 (2010: HK$2,624m).

a *Debt securities*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**17,880**	21,713	**13,329**	17,837
– listed outside Hong Kong	**54,897**	81,496	**54,180**	81,228
	72,777	103,209	**67,509**	99,065
Unlisted	**96,072**	97,170	**53,066**	56,109
	168,849	200,379	**120,575**	155,174
Issued by public bodies				
– central governments and central banks	**114,322**	143,684	**77,477**	103,286
– other public sector entities	**6,651**	9,266	**6,544**	9,165
	120,973	152,950	**84,021**	112,451
Issued by				
– banks	**23,984**	26,424	**19,811**	25,380
– corporate entities	**23,892**	21,005	**16,743**	17,343
	168,849	200,379	**120,575**	155,174

b *Equity shares*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**4,494**	3,711	**4,487**	3,702
– listed outside Hong Kong	**7,211**	10,910	**7,211**	10,910
	11,705	14,621	**11,698**	14,612
Unlisted	**3,355**	3,177	**3,280**	3,008
	15,060	17,798	**14,978**	17,620
Issued by				
– banks	**2,192**	1,287	**2,192**	1,287
– corporate entities	**12,868**	16,511	**12,786**	16,333
	15,060	17,798	**14,978**	17,620

Notes on the Financial Statements (continued)

16 Financial assets designated at fair value

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**16,762**	17,299	**2,283**	2,086
Equity shares	**40,268**	36,674	**–**	–
Other	**640**	631	**–**	–
	57,670	54,604	**2,283**	2,086

a *Debt securities*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**1,780**	1,909	**587**	826
– listed outside Hong Kong	**4,578**	4,297	**1,696**	1,111
	6,358	6,206	**2,283**	1,937
Unlisted	**10,404**	11,093	**–**	149
	16,762	17,299	**2,283**	2,086
Issued by public bodies				
– central governments and central banks	**2,298**	2,266	**587**	593
– other public sector entities	**1,992**	2,402	**–**	270
	4,290	4,668	**587**	863
Issued by other bodies				
– banks	**5,153**	5,757	**–**	–
– corporate entities	**7,319**	6,874	**1,696**	1,223
	16,762	17,299	**2,283**	2,086

b *Equity shares*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**3,354**	4,299	**–**	–
– listed outside Hong Kong	**14,732**	13,907	**–**	–
	18,086	18,206	**–**	–
Unlisted	**22,182**	18,468	**–**	–
	40,268	36,674	**–**	–
Issued by				
– banks	**1,386**	1,677	**–**	–
– corporate entities	**38,882**	34,997	**–**	–
	40,268	36,674	**–**	–

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 utilised to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures as are used for traditional lending.

a *Trading and hedging derivatives*

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives and ineffective hedging derivatives 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.

Notes on the Financial Statements (continued)

17 Derivatives *(continued)*

(i) 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

	2011			2010		
	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	**10,996,534**	**172,868**	**181,560**	8,815,181	159,046	166,839
Interest rate contracts	**17,283,126**	**166,195**	**161,430**	15,566,345	120,045	118,337
Equity derivatives	**785,433**	**29,729**	**31,066**	456,339	16,424	16,275
Credit derivatives	**465,174**	**5,000**	**4,784**	531,899	5,233	4,968
Commodity and other	**87,764**	**2,713**	**1,054**	38,530	487	660
Total held for trading	**29,618,031**	**376,505**	**379,894**	25,408,294	301,235	307,079
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**546**	**3**	**–**	19,483	37	9
Interest rate contracts	**4,835**	**128**	**95**	8,105	32	137
	5,381	**131**	**95**	27,588	69	146
Cash flow hedging derivatives						
Exchange rate contracts	**2,679**	**–**	**79**	–	–	–
Interest rate contracts	**101,069**	**271**	**139**	250,303	896	125
	103,748	**271**	**218**	250,303	896	125
Fair value hedging derivatives						
Interest rate contracts	**109,477**	**389**	**3,045**	113,458	422	2,488
Total derivatives	**29,836,637**	**377,296**	**383,252**	25,799,643	302,622	309,838

17 Derivatives *(continued)*

The Bank

	2011			2010		
	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	**10,080,072**	**168,229**	**178,375**	8,076,965	154,314	163,163
Interest rate contracts	**16,979,848**	**164,555**	**159,977**	15,323,156	118,579	116,788
Equity derivatives	**791,046**	**30,013**	**30,959**	459,264	16,242	16,509
Credit derivatives	**465,174**	**5,024**	**4,797**	531,887	5,296	5,119
Commodity and other	**68,406**	**2,409**	**1,512**	31,436	239	649
Total held for trading	**28,384,546**	**370,230**	**375,620**	24,422,708	294,670	302,228
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**546**	**3**	**–**	684	37	9
Interest rate contracts	**4,695**	**128**	**92**	5,780	32	128
	5,241	**131**	**92**	6,464	69	137
Cash flow hedging derivatives						
Exchange rate contracts	**2,679**	**–**	**79**	–	–	–
Interest rate contracts	**41,253**	**167**	**31**	124,688	618	43
	43,932	**167**	**110**	124,688	618	43
Fair value hedging derivatives						
Interest rate contracts	**53,767**	**150**	**1,343**	72,976	122	1,474
Total derivatives	**28,487,486**	**370,678**	**377,165**	24,626,836	295,479	303,882

(ii) Risk exposure by counterparty type excluding HSBC entities

	2011		2010	
	The group %	**The Bank %**	The group %	The Bank %
Government	**–**	**–**	–	–
Banks	**75**	**76**	78	79
Other financial institutions	**11**	**11**	8	8
Other	**14**	**13**	14	13
Total	**100**	**100**	100	100

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the 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 2012 and beyond.

Notes on the Financial Statements (continued)

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

	2011 HK$m	2010 HK$m
Gains/(losses):		
On hedging instruments	**(1,147)**	(579)
On the hedged items attributable to hedged risk	**1,050**	563
	(97)	(16)

Cash flow hedges

The group's cash flow hedges consist principally of interest rate swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their own contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised directly in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2011, the amount transferred to the income statement comprised HK$324m (2010: HK$1,430m) 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 2011, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2010: gain of HK$5m).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2011 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 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**
At 31 December 2010			
Cash inflows from assets	177,416	96,529	31,841
Cash outflows from liabilities	(4,301)	(4,003)	(2,574)
Net cash inflows	173,115	92,526	29,267

17 Derivatives *(continued)*

b *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

	2011 HK$m	2010 HK$m
Balance at 1 January	**101**	128
Deferrals on new transactions	**225**	94
Reduction due to amortisation	**(86)**	(55)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(101)**	(69)
Exchange differences and others	**(2)**	3
Balance at 31 December	**137**	101

The Bank

	2011 HK$m	2010 HK$m
Balance at 1 January	**91**	124
Deferrals on new transactions	**195**	81
Reduction due to amortisation	**(71)**	(55)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(89)**	(62)
Exchange differences and others	**(2)**	3
Balance at 31 December	**124**	91

18 Loans and advances to customers

a *Loans and advances to customers*

	The group		The Bank	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Gross loans and advances to customers	**2,142,172**	1,904,054	**1,184,316**	1,025,285
Impairment allowances (note 19(a))	**(11,301)**	(12,994)	**(7,714)**	(8,973)
	2,130,871	1,891,060	**1,176,602**	1,016,312

Notes on the Financial Statements (continued)

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 Hongkong and Shanghai Banking Corporation Limited and its subsidiaries, to manage associated risks.

The group

2011	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
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**
2010			
Residential mortgages[1]	326,767	221,558	548,325
Credit card advances	37,351	34,287	71,638
Other personal	47,874	37,779	85,653
Total personal	411,992	293,624	705,616
Commercial, industrial and international trade	260,020	325,253	585,273
Commercial real estate	150,142	67,804	217,946
Other property-related lending	118,401	42,231	160,632
Government	18,185	3,223	21,408
Other commercial	78,676	93,569	172,245
Total corporate and commercial	625,424	532,080	1,157,504
Non-bank financial institutions	21,952	16,486	38,438
Settlement accounts	2,020	476	2,496
Total financial	23,972	16,962	40,934
Gross loans and advances to customers	1,061,388	842,666	1,904,054
Individually assessed impairment allowances	(2,615)	(5,644)	(8,259)
Collectively assessed impairment allowances	(2,178)	(2,557)	(4,735)
Net loans and advances to customers	1,056,595	834,465	1,891,060

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$25,640m (2010: HK$27,496m).*

18 Loans and advances to customers *(continued)*

The Bank

2011	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
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**
2010			
Residential mortgages[1]	181,599	85,761	267,360
Credit card advances	21,616	14,942	36,558
Other personal	27,833	19,451	47,284
Total personal	231,048	120,154	351,202
Commercial, industrial and international trade	162,419	157,112	319,531
Commercial real estate	112,390	36,477	148,867
Other property-related lending	26,686	19,513	46,199
Government	17,463	3,137	20,600
Other commercial	53,106	54,494	107,600
Total corporate and commercial	372,064	270,733	642,797
Non-bank financial institutions	19,931	11,240	31,171
Settlement accounts	–	115	115
Total financial	19,931	11,355	31,286
Gross loans and advances to customers	623,043	402,242	1,025,285
Individually assessed impairment allowances	(1,775)	(4,171)	(5,946)
Collectively assessed impairment allowances	(1,589)	(1,438)	(3,027)
Net loans and advances to customers	619,679	396,633	1,016,312

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$11,235m (2010: HK$12,663m).*

Notes on the Financial Statements (continued)

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

	2011			2010		
	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	**3,022**	**686**	**3,708**	2,947	562	3,509
– After one year but within five years	**7,241**	**1,701**	**8,942**	7,104	1,441	8,545
– After five years	**13,198**	**1,661**	**14,859**	13,071	2,034	15,105
	23,461	**4,048**	**27,509**	23,122	4,037	27,159
Impairment allowances	**(54)**			(62)		
Net investment in finance leases and hire purchase contracts	**23,407**			23,060		

The Bank

	2011			2010		
	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	**1,640**	**272**	**1,912**	1,803	247	2,050
– After one year but within five years	**3,938**	**764**	**4,702**	4,045	644	4,689
– After five years	**8,871**	**1,207**	**10,078**	6,917	824	7,741
	14,449	**2,243**	**16,692**	12,765	1,715	14,480
Impairment allowances	**(10)**			(21)		
Net investment in finance leases and hire purchase contracts	**14,439**			12,744		

19 Impairment allowances against loans and advances to customers

a *Impairment allowances against loans and advances to customers*

The group

2011	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
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**
2010			
At 1 January	8,088	6,192	14,280
Amounts written off	(1,995)	(5,326)	(7,321)
Recoveries of loans and advances written off in previous years	322	1,442	1,764
Net charge to income statement (note 4(i))	2,214	2,474	4,688
Unwinding of discount of loan impairment	(81)	(243)	(324)
Exchange and other adjustments	(289)	196	(93)
At 31 December (note 18(a))	8,259	4,735	12,994

The Bank

2011	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
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**
2010			
At 1 January	5,371	4,480	9,851
Amounts written off	(1,220)	(3,835)	(5,055)
Recoveries of loans and advances written off in previous years	119	968	1,087
Net charge to income statement	1,727	1,796	3,523
Unwinding of discount of loan impairment	(47)	(190)	(237)
Exchange and other adjustments	(4)	(192)	(196)
At 31 December (note 18(a))	5,946	3,027	8,973

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers *(continued)*

b *Impaired loans and advances to customers and allowances*

The group

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2011			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances[1]	**4,538**	**9,313**	**13,851**
Individually assessed allowances	**(2,174)**	**(4,720)**	**(6,894)**
	2,364	**4,593**	**6,957**
Individually assessed allowances as a percentage of gross impaired loans and advances	**47.9%**	**50.7%**	**49.8%**
Gross impaired loans and advances as a percentage of gross loans and advances to customers	**0.4%**	**1.0%**	**0.6%**
At 31 December 2010			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances[1]	4,987	11,294	16,281
Individually assessed allowances	(2,615)	(5,644)	(8,259)
	2,372	5,650	8,022
Individually assessed allowances as a percentage of gross impaired loans and advances	52.4%	50.0%	50.7%
Gross impaired loans and advances as a percentage of gross loans and advances to customers	0.5%	1.3%	0.9%

The Bank

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2011			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances[1]	**3,086**	**5,865**	**8,951**
Individually assessed allowances	**(1,377)**	**(3,608)**	**(4,985)**
	1,709	**2,257**	**3,966**
Individually assessed allowances as a percentage of gross impaired loans and advances	**44.6%**	**61.5%**	**55.7%**
Gross impaired loans and advances as a percentage of gross loans and advances to customers	**0.4%**	**1.4%**	**0.8%**
At 31 December 2010			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances[1]	3,436	7,160	10,596
Individually assessed allowances	(1,775)	(4,171)	(5,946)
	1,661	2,989	4,650
Individually assessed allowances as a percentage of gross impaired loans and advances	51.7%	58.3%	56.1%
Gross impaired loans and advances as a percentage of gross loans and advances to customers	0.6%	1.8%	1.0%

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

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

19 Impairment allowances against loans and advances to customers *(continued)*

c *Individually assessed impaired loans and advances*

The group

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2011			
Gross individually assessed impaired loans and advances	**3,881**	**8,490**	**12,371**
Individually assessed impairment allowances	**(2,174)**	**(4,720)**	**(6,894)**
	1,707	**3,770**	**5,477**
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	**0.3%**	**0.9%**	**0.6%**
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**
At 31 December 2010			
Gross individually assessed impaired loans and advances	4,804	10,210	15,014
Individually assessed impairment allowances	(2,615)	(5,644)	(8,259)
	2,189	4,566	6,755
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	0.5%	1.2%	0.8%
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,463	2,887	4,350

The Bank

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2011			
Gross individually assessed impaired loans and advances	**2,520**	**5,472**	**7,992**
Individually assessed impairment allowances	**(1,377)**	**(3,608)**	**(4,985)**
	1,143	**1,864**	**3,007**
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	**0.3%**	**1.3%**	**0.7%**
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**
At 31 December 2010			
Gross individually assessed impaired loans and advances	3,359	6,521	9,880
Individually assessed impairment allowances	(1,775)	(4,171)	(5,946)
	1,584	2,350	3,934
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	0.5%	1.6%	1.0%
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	877	879	1,756

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers *(continued)*

For individually assessed customer loans and advances where the industry sectors comprise more than 10% of 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 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**
At 31 December 2010						
Residential mortgages	548,325	2,405	(375)	(216)	4	78
Commercial, industrial and international trade	585,273	8,445	(5,989)	(1,898)	1,096	1,049
Commercial real estate	217,946	893	(254)	(54)	76	192

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 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**
At 31 December 2010						
Residential mortgages	267,360	637	(95)	(98)	(27)	43
Commercial, industrial and international trade	319,531	6,173	(4,395)	(1,198)	915	883
Commercial real estate	148,867	349	(60)	(22)	20	116

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.

19 Impairment allowances against loans and advances to customers *(continued)*

d *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 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**
At 31 December 2010						
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	341	0.0	1,906	0.2	2,247	0.1
– more than six months but less than one year	974	0.1	825	0.1	1,799	0.1
– more than one year	2,234	0.2	4,345	0.5	6,579	0.4
	3,549	0.3	7,076	0.8	10,625	0.6
Individually assessed impairment allowances made in respect of amounts overdue	(1,923)		(3,824)		(5,747)	
Fair value of collateral held in respect of amounts overdue	823		2,044		2,867	
Rescheduled loans and advances to customers	891	0.1	2,793	0.3	3,684	0.2

Notes on the Financial Statements (continued)

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 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**
At 31 December 2010						
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	204	0.0	854	0.2	1,058	0.1
– more than six months but less than one year	886	0.2	391	0.1	1,277	0.1
– more than one year	1,330	0.2	2,574	0.6	3,904	0.4
	2,420	0.4	3,819	0.9	6,239	0.6
Individually assessed impairment allowances made in respect of amounts overdue	(1,115)		(2,496)		(3,611)	
Fair value of collateral held in respect of amounts overdue	529		607		1,136	
Rescheduled loans and advances to customers	772	0.1	1,251	0.3	2,023	0.2

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 loans and advances to customers’.

20 Impairments 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 2011 and 31 December 2010. Information relating to overdue balances can be found in note 52.

21 Financial investments

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Debt securities				
– held-to-maturity	**134,720**	121,743	**–**	–
– available-for-sale	**542,536**	632,084	**325,136**	442,336
Equity shares				
– available-for-sale	**45,177**	72,835	**37,171**	61,416
	722,433	826,662	**362,307**	503,752
Financial investments				
– which may be repledged or resold by counterparties	**847**	1,297	**325**	1,090
– not subject to repledge or resale by counterparties	**721,586**	825,365	**361,982**	502,662
	722,433	826,662	**362,307**	503,752

a *Held-to-maturity debt securities*

The group

	Book value		Fair value	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**2,932**	2,496	**3,209**	2,733
– listed outside Hong Kong	**31,017**	30,013	**32,847**	30,941
	33,949	32,509	**36,056**	33,674
Unlisted	**100,771**	89,234	**106,618**	92,737
	134,720	121,743	**142,674**	126,411
Issued by public bodies				
– central governments and central banks	**2,551**	2,309	**3,049**	2,471
– other public sector entities	**20,703**	18,074	**22,347**	19,230
	23,254	20,383	**25,396**	21,701
Issued by				
– banks	**72,303**	72,428	**75,309**	74,876
– corporate entities	**39,163**	28,932	**41,969**	29,834
	134,720	121,743	**142,674**	126,411

Notes on the Financial Statements (continued)

21 Financial investments *(continued)*

b *Available-for-sale debt securities*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**23,333**	9,519	**2,872**	1,337
– listed outside Hong Kong	**169,312**	261,968	**131,216**	200,125
	192,645	271,487	**134,088**	201,462
Unlisted	**349,891**	360,597	**191,048**	240,874
	542,536	632,084	**325,136**	442,336
Issued by public bodies				
– central governments and central banks	**295,436**	263,426	**182,580**	199,397
– other public sector entities	**78,901**	63,972	**51,118**	46,542
	374,337	327,398	**233,698**	245,939
Issued by				
– banks	**136,388**	257,408	**74,434**	159,631
– corporate entities	**31,811**	47,278	**17,004**	36,766
	542,536	632,084	**325,136**	442,336

c *Available-for-sale equity shares*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**31,794**	53,867	**31,372**	53,224
– listed outside Hong Kong	**129**	699	**89**	529
	31,923	54,566	**31,461**	53,753
Unlisted	**13,254**	18,269	**5,710**	7,663
	45,177	72,835	**37,171**	61,416
Issued by				
– banks	**7,140**	11,376	**3,716**	4,957
– corporate entities	**38,037**	61,459	**33,455**	56,459
	45,177	72,835	**37,171**	61,416

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. The following table analyses the carrying amount of financial assets transferred to third parties that did not qualify for derecognition during 2011 and 2010, and their associated financial liabilities:

The group

	2011		2010	
	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	**21,685**	**21,383**	14,652	14,210
Securities lending agreements	**735**	**259**	594	65
	22,420	**21,642**	15,246	14,275

The Bank

	2011		2010	
	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	**3,829**	**3,888**	6,692	6,485
Securities lending agreements	**579**	**259**	387	65
	4,408	**4,147**	7,079	6,550

The carrying amount of assets transferred by the group to other HSBC Group entities under repurchase agreements is HK$12,276m (2010: HK$48m) and by the Bank is HK$15,452m (2010: HK$11,647m). The associated liability assumed by the group is HK$12,292m (2010: HK$48m) and by the Bank is HK$15,462m (2010: HK$11,715m).

The carrying amount of assets transferred under securities lending agreements to other HSBC Group entities is HK$3,534m (2010: HK$2,341m) by both the group and the Bank. The associated liabilities assumed are HK$3,534m (2010: HK$2,458m).

Notes on the Financial Statements (continued)

23 Investments in subsidiaries

	The Bank 2011 HK$m	The Bank 2010 HK$m
Investments in subsidiaries:		
Unlisted investments	**56,859**	52,059
Listed investment	**865**	865
	57,724	52,924

The principal subsidiaries of the Bank are:

	Place of incorporation	Principal activity	Nominal value of issued share capital	Class of share	The group's interest in issued share capital
Hang Seng Bank Limited	Hong Kong	Banking	HK$9,559m	Ordinary	62.14%
HSBC Bank (China) Company Limited	PRC[1]	Banking	RMB10,800m	Ordinary	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	RM$115m	Ordinary	100%
HSBC Bank Australia Limited[2]	Australia	Banking	A$751m	Ordinary	100%
HSBC Bank (Taiwan) Limited[2]	Taiwan	Banking	TWD30,000m	Ordinary	100%
HSBC Insurance (Asia) Limited[2]	Hong Kong	Insurance	HK$1,298m	Ordinary	100%
HSBC Life (International) Limited[2]	Bermuda	Retirement benefits and life insurance	HK$1,278m	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.

24 Interests in associates and joint ventures

	The Group	
	2011	2010
	HK$m	HK$m
Share of net assets	**84,493**	68,046
Goodwill	**5,544**	5,405
Intangible assets	**2,216**	2,690
Deferred tax on intangible assets	**(468)**	(573)
	91,785	75,568

At 31 December 2011, the group's interests in associates amounted to HK$90,130m (2010: HK$74,099m).

	The Bank	
	2011	2010
	HK$m	HK$m
Listed investments	**26,561**	26,561
Unlisted investments	**1,578**	1,578
	28,139	28,139

Shareholdings in associates held by the Bank include listed investments of HK$26,561m (2010: 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$87,107m (2010: HK$108,458m).

a *Principal associates*

The principal associates of the group are:

	At 31 December 2011		At 31 December 2010	
	Carrying value HK$m	**Fair value HK$m**	Carrying value HK$m	Fair value HK$m
Listed				
Bank of Communications Co., Ltd	**66,704**	**63,964**	54,568	83,743
Industrial Bank Co., Ltd.[3]	**17,199**	**21,307**	13,752	21,753
Bao Viet Holdings[3]	**1,409**	**1,836**	1,418	2,962
	85,312	**87,107**	69,738	108,458

	Place of incorporation	**Principal activity**	**Nominal value of issued share capital**	**Class of share**	**The group's interest in issued share capital**
Listed					
Bank of Communications Co., Ltd	PRC[1]	Banking	RMB61,886m	Ordinary	19.03%
Industrial Bank Co., Ltd.[3]	PRC[1]	Banking	RMB10,786m	Ordinary	12.80%
Bao Viet Holdings[3]	Vietnam	Insurance	VND6,805bn	Ordinary	18.00%
Unlisted					
Barrowgate Limited[3]	Hong Kong	Property investment	–[2]	Ordinary	24.64%
OCLP Holdings, Inc.	Philippines	Property investment	PHP1,672m	Ordinary	34.08%
Vietnam Technological and Commercial Joint Stock Bank	Vietnam	Banking	VND8,788bn	Ordinary	19.61%
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 Bank's interests in Bank of Communications Co., Ltd ('BoCom'), Vietnam Technological and Commercial Joint Stock Bank ('TechCom Bank') and Bao Viet Holdings ('Bao Viet') are accounted for as associated companies as the group has representation on the Board of Directors of each, whilst for BoCom, the Bank has representation on the strategy committee. Hang Seng Bank Limited's ('Hang Seng') interest in Industrial Bank Co., Ltd. ('Industrial Bank') is accounted for as an associated company as Hang Seng has representation on the Board of Directors and also has representation on the executive committee.

In respect of the year ended 31 December 2011, BoCom, Industrial Bank, TechCom Bank and Bao Viet were included in these financial statements based on financial statements drawn up to 30 September 2011, but taking into account the financial effect of significant transactions or events in the subsequent period from 1 October 2011 to 31 December 2011. The group has taken advantage of the provision contained in HKAS28 '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.

In September 2011, TechCom Bank issued shares to its employees. This reduced the group's equity interest from 19.79% to 19.61%.

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.

The group has entered into Technical Support and Assistance Agreements with BoCom, Industrial Bank, TechCom Bank, Bao Viet, 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.

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
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**
2010						
100%	6,754,826	6,368,911	385,915	175,768	110,321	65,447
The group's effective interest[1]	1,053,418	991,097	62,321	29,268	18,717	10,551

1 *The group's effective interest is stated net of non-controlling interests.*

At 31 December 2011, the group's share of associates and joint ventures' contingent liabilities was HK$266,530m (2010: HK$199,304m).

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	INR8,000m	Ordinary	26.00%
Hana HSBC Life Insurance Co., Ltd	South Korea	Insurance manufacturing	KRW85,201m	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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Goodwill	**7,629**	7,891	**1,177**	1,167
Present value of in-force long-term insurance business	**20,232**	14,767	**–**	–
Other intangible assets	**6,978**	7,032	**3,654**	3,546
	34,839	29,690	**4,831**	4,713

a *Goodwill*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Cost at 1 January	**7,891**	7,519	**1,167**	1,104
Exchange and other movements	**(262)**	372	**10**	63
Net book value at 31 December	**7,629**	7,891	**1,177**	1,167

Segmental analysis of goodwill

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong – Retail Banking and Wealth Management	**12**	12	**–**	–
Hong Kong – Commercial Banking	**36**	36	**24**	24
Hong Kong – Global Banking and Markets	**755**	755	**498**	498
Rest of Asia-Pacific – Retail Banking and Wealth Management	**1,430**	1,598	**78**	78
Rest of Asia-Pacific – Commercial Banking	**4,275**	4,358	**–**	–
Rest of Asia-Pacific – Global Banking and Markets	**1,121**	1,132	**577**	567
	7,629	7,891	**1,177**	1,167

During 2011 there was no impairment of goodwill (2010: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs'), determined at 1 July 2011 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.

Notes on the Financial Statements (continued)

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 2011 were in the range of 10% to 11% (2010: 10% to 11%) across different CGUs. The nominal long-term growth rates used in the impairment test in 2011 for Hong Kong and Rest of Asia-Pacific were 7.9% and 7.8% respectively (2010: 5.3% and 6.9%).

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:

	2011	2010
Risk free rate	**1.47%**	3.10%
Risk discount rate	**8.00%**	11.00%
Expenses inflation	**3.00%**	3.00%
Lapse rate	**0%-20% for the first policy year and 0%-15% for renewal 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	
	2011	2010
	HK$m	HK$m
At 1 January	**14,767**	10,554
Addition from current year new business	**4,982**	3,737
Movement from in-force business	**(333)**	369
Exchange and other adjustments	**816**	107
At 31 December	**20,232**	14,767

25 Goodwill and intangible assets *(continued)*

c *Other intangible assets*

The group

	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**

	2010			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other[1] HK$m	Total HK$m
Cost				
At 1 January	6,866	1,743	2,090	10,699
Additions	1,345	–	28	1,373
Disposals/amounts written-off	(82)	–	–	(82)
Exchange and other movements	79	162	200	441
At 31 December	8,208	1,905	2,318	12,431
Accumulated amortisation and impairment				
At 1 January	3,203	479	21	3,703
Amortisation charge for the year	1,374	195	10	1,579
Impairment	85	–	–	85
Disposals/amounts written-off	(82)	–	–	(82)
Exchange and other movements	60	53	1	114
At 31 December	4,640	727	32	5,399
Net book value at 31 December	3,568	1,178	2,286	7,032

Notes on the Financial Statements (continued)

25 Goodwill and intangible assets *(continued)*

The Bank

	2011			
	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other[1] 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**

	2010			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other[1] HK$m	Total HK$m
Cost				
At 1 January	5,557	1,135	1,975	8,667
Additions	1,071	–	2	1,073
Disposals/amounts written-off	(150)	–	–	(150)
Exchange and other movements[2]	(54)	134	(1,965)	(1,885)
At 31 December	6,424	1,269	12	7,705
Accumulated amortisation and impairment				
At 1 January	2,648	361	8	3,017
Amortisation charge for the year	1,115	95	–	1,210
Impairment	80	–	–	80
Disposals/amounts written-off	(150)	–	–	(150)
Exchange and other movements	(46)	47	1	2
At 31 December	3,647	503	9	4,159
Net book value at 31 December	2,777	766	3	3,546

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.*

2 *Other intangible assets arising from the acquisition of the assets, liabilities and operations of The Chinese Bank in Taiwan were transferred from the Bank to the group following the local incorporation of HSBC Bank (Taiwan) Limited in 2010.*

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 2011. 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 2011 was in the range of 12% to 13% (2010: 11% to 12%). The long-term growth rate used in the impairment testing during 2011 was 3% (2010: 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 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

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 2010	50,103	3,114	18,460	31,584	126	12,281
Exchange and other adjustments	429	–	497	168	–	(161)
Additions	4,026	–	2,132	4,022	–	1,356
Disposals	(43)	–	(543)	(17)	–	(316)
Elimination of accumulated depreciation on revalued land and buildings	(1,285)	–	–	(778)	–	–
Surplus on revaluation	10,038	483	–	6,444	–	–
Reclassifications	(120)	(94)	(16)	–	–	(11)
At 31 December 2010	63,148	3,503	20,530	41,423	126	13,149
Accumulated depreciation						
At 1 January 2010	11	–	12,856	–	–	8,650
Exchange and other adjustments	2	–	338	2	–	(81)
Charge for the year	1,279	–	2,146	781	–	1,376
Disposals	(5)	–	(495)	(5)	–	(298)
Elimination of accumulated depreciation on revalued land and buildings	(1,285)	–	–	(778)	–	–
Reclassifications	–	–	(13)	–	–	(10)
At 31 December 2010	2	–	14,832	–	–	9,637
Net book value at 31 December 2010	63,146	3,503	5,698	41,423	126	3,512
Total at 31 December 2010			72,347			45,061

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	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Cost less accumulated depreciation	**19,575**	19,475	**14,541**	14,507

c *An analysis of land and buildings carried at valuation or cost (before deduction of accumulated depreciation) is as follows:*

	The group		The Bank	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Land and buildings carried at valuation	**74,901**	62,956	**48,318**	41,423
Other land and buildings stated at cost	**189**	192	**–**	–
Land and buildings before deduction of accumulated depreciation	**75,090**	63,148	**48,318**	41,423

26 Property, plant and equipment *(continued)*

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

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Long leaseholds (over fifty years)	**34,787**	28,263	**29,818**	24,626
Medium-term leaseholds (between ten and fifty years)	**34,182**	28,269	**10,004**	8,837
Short leaseholds (less than ten years)	**90**	136	**90**	100
	69,059	56,668	**39,912**	33,563
Outside Hong Kong:				
Freehold	**4,444**	4,287	**3,489**	3,361
Long leaseholds (over fifty years)	**157**	125	**112**	82
Medium-term leaseholds (between ten and fifty years)	**5,978**	5,527	**4,905**	4,501
Short leaseholds (less than ten years)	**47**	42	**47**	42
	10,626	9,981	**8,553**	7,986
	79,685	66,649	**48,465**	41,549
Analysed as follows:				
Land and buildings	**75,069**	63,146	**48,318**	41,423
Investment properties	**4,616**	3,503	**147**	126
	79,685	66,649	**48,465**	41,549

The group's land and buildings and investment properties were revalued at 30 November 2011 and updated for any material changes at 31 December 2011. 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$9,384m (2010: HK$8,931m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK$13,981m (2010: HK$10,521m). Amounts of HK$9,656m (2010: HK$7,513m) and HK$1,041m (2010: HK$585m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$9,656m (2010: HK$7,513m) is stated after deduction of non-controlling interests of HK$1,412m (2010: HK$796m) and deferred tax of HK$1,872m (2010: HK$1,627m). The amount credited to the income statement comprises the surplus of HK$1,033m (2010: HK$483m) on revaluation of investment properties, and HK$8m (2010: HK$102m) 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, the Macau SAR and mainland China, representing 94% by value of the group's properties subject to valuation, were valued by DTZ Debenham Tie Leung Limited who 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 6% 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$191m (2010: HK$170m) was recognised as rental income in the income statement in respect of operating leases.

The total future minimum lease payments under non-cancellable operating leases receivable are as follows:

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**163**	130	**9**	5
After one but within five years	**92**	93	**18**	–
	255	223	**27**	5

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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Medium-term leaseholds (between ten and fifty years)	**330**	348	**77**	79

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 28).

28 Other assets

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Current taxation recoverable	**676**	335	**550**	208
Assets held for sale	**8,117**	257	**8,005**	6
Prepayments and accrued income	**3,135**	3,218	**1,558**	1,468
Accrued interest receivable	**14,524**	11,678	**5,774**	5,813
Acceptances and endorsements	**31,750**	25,892	**21,001**	17,041
Other accounts	**42,002**	19,527	**20,050**	7,337
	100,204	60,907	**56,938**	31,873

Assets held for sale comprised assets acquired by repossession of collateral for realisation, own properties held for sale and assets of businesses to be sold.

On 21 December 2011, the group entered into an agreement to sell HSBC's private banking business in Japan to Credit Suisse AG and Credit Suisse Securities (Japan) Limited. The transaction is subject to regulatory approvals and is expected to complete during the first half of 2012.

On 25 January 2012, the group entered into an agreement to sell HSBC's retail banking and wealth management business in Thailand to Bank of Ayudhya Public Company Limited. The transaction is subject to regulatory approvals and is expected to complete during the first half of 2012.

29 Customer accounts

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Current accounts	**696,435**	643,850	**410,911**	376,925
Savings accounts	**1,826,893**	1,765,835	**1,275,503**	1,204,293
Other deposit accounts	**1,041,673**	903,559	**533,658**	463,446
	3,565,001	3,313,244	**2,220,072**	2,044,664

30 Trading liabilities

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit in issue	**5,790**	2,694	**1,379**	1,667
Other debt securities in issue	**15,738**	17,919	**14,999**	14,710
Short positions in securities	**44,891**	51,089	**18,780**	31,665
Deposits by banks	**6,642**	11,103	**5,911**	10,428
Customer accounts	**98,370**	68,729	**37,890**	32,714
	171,431	151,534	**78,959**	91,184

31 Financial liabilities designated at fair value

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Deposits by banks	**302**	288	**302**	288
Customer accounts	**1,618**	1,688	**1,618**	1,688
Debt securities in issue	**3,990**	4,605	**3,990**	4,605
Liabilities to customers under investment contracts	**34,482**	33,746	**–**	–
	40,392	40,327	**5,910**	6,581

At 31 December 2011, the carrying amount of financial liabilities designated at fair value was HK$56m higher than the contractual amount at maturity (2010: the carrying amount was HK$38m lower than the contractual amount). At 31 December 2011, the accumulated gain in fair value attributable to changes in credit risk was HK$9m (2010: the accumulated loss was HK$5m).

32 Debt securities in issue

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit	**37,281**	36,222	**18,871**	30,368
Other debt securities	**40,191**	23,061	**27,489**	12,771
	77,472	59,283	**46,360**	43,139

Notes on the Financial Statements (continued)

33 Other liabilities and provisions

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**23,286**	22,502	**13,441**	13,757
Liabilities held for sale	**21,970**	–	**21,970**	–
Provisions for liabilities and charges (note 35)	**1,686**	1,359	**1,184**	858
Acceptances and endorsements	**31,750**	25,950	**21,001**	17,099
Share based payment liability to HSBC Holdings plc	**2,729**	1,812	**2,212**	1,413
Other liabilities	**26,893**	19,323	**11,777**	10,905
	108,314	70,946	**71,585**	44,032

34 Liabilities under insurance contracts issued

	Gross	**Reinsurance**	**Net**
	HK$m	**HK$m**	**HK$m**
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**
Investment contracts with discretionary participation features	**86**	**–**	**86**
Life (linked)	**30,055**	**(6,666)**	**23,389**
	206,379	**(6,894)**	**199,485**
Total liabilities under insurance contracts	**209,438**	**(7,289)**	**202,149**
2010			
Non-life insurance liabilities			
Unearned premiums	1,495	(158)	1,337
Notified claims	1,008	(219)	789
Claims incurred but not reported	295	(43)	252
Other	122	–	122
	2,920	(420)	2,500
Life insurance liabilities to policyholders			
Life (non-linked)	145,960	(161)	145,799
Investment contracts with discretionary participation features	170	–	170
Life (linked)	28,920	(5,567)	23,353
	175,050	(5,728)	169,322
Total liabilities under insurance contracts	177,970	(6,148)	171,822

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

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
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**
2010			
Unearned premiums			
At 1 January	1,233	(113)	1,120
Gross written premiums	3,166	(457)	2,709
Gross earned premiums	(2,931)	416	(2,515)
Foreign exchange and other movements	27	(4)	23
At 31 December	1,495	(158)	1,337
Notified and incurred but not reported claims			
At 1 January	1,273	(273)	1,000
– Notified claims	953	(235)	718
– Claims incurred but not reported	320	(38)	282
Claims paid in current year	(1,290)	160	(1,130)
Claims incurred	1,276	(140)	1,136
Foreign exchange and other movements	44	(9)	35
At 31 December			
– Notified claims	1,008	(219)	789
– Claims incurred but not reported	295	(43)	252
Total at 31 December	1,303	(262)	1,041

Notes on the Financial Statements (continued)

34 Liabilities under insurance contracts issued *(continued)*

(ii) Life insurance liabilities to policyholders

	Gross HK$m	Reinsurance HK$m	Net HK$m
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 policyholders' liabilities	**206,379**	**(6,894)**	**199,485**
2010			
Life (non-linked)			
At 1 January	116,180	(67)	116,113
Benefits paid	(4,030)	157	(3,873)
Increase in liabilities to policyholders	32,896	(154)	32,742
Foreign exchange and other movements	914	(97)	817
At 31 December	145,960	(161)	145,799
Life (linked)			
At 1 January	25,846	(6,237)	19,609
Benefits paid	(2,330)	298	(2,032)
Increase in liabilities to policyholders	5,002	960	5,962
Foreign exchange and other movements	402	(588)	(186)
At 31 December	28,920	(5,567)	23,353
Investment contracts with discretionary participation features			
At 1 January	269	–	269
Benefits paid	(122)	–	(122)
Increase in liabilities to policyholders	3	–	3
Foreign exchange and other movements	20	–	20
At 31 December	170	–	170
Total policyholders' liabilities	175,050	(5,728)	169,322

35 Provisions for liabilities and charges

Provisions for liabilities and charges

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**1,359**	1,226	**858**	800
Additional provisions/increase in provisions	**767**	195	**707**	184
Provisions utilised	**(276)**	(114)	**(243)**	(96)
Amounts reversed	**(85)**	(68)	**(54)**	(52)
Exchange and other movements	**(79)**	120	**(84)**	22
At 31 December	**1,686**	1,359	**1,184**	858

Of which: provisions for restructuring costs

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**83**	22	**77**	–
Additional provisions/increase in provisions	**631**	134	**580**	122
Provisions utilised	**(233)**	(77)	**(211)**	(45)
Amounts reversed	**(8)**	(2)	**(2)**	–
Exchange and other movements	**3**	6	**(5)**	–
At 31 December	**476**	83	**439**	77

36 Subordinated liabilities

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

		2011	2010
		HK$m	HK$m
The Bank			
US$1,200m	Undated floating rate primary capital notes	**9,386**	9,404
		9,386	9,404
The group			
A$200m	Floating rate subordinated notes due 2016, callable from 2011[1]	**–**	1,583
A$42m	Floating rate subordinated notes due 2018, callable from 2013[2]	**332**	332
A$200m	Floating rate subordinated notes due 2020, callable from 2015	**1,580**	1,583
US$450m	Floating rate subordinated notes due 2016, callable from 2011[3]	**–**	3,495
US$300m	Floating rate subordinated notes due 2017, callable from 2012[4]	**2,328**	2,328
RM500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017[5]	**1,227**	1,263
RM500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022[6]	**1,261**	1,266
		16,114	21,254

1 *The A$200m callable subordinated floating rate notes due 2016 were redeemed in May 2011.*
2 *The interest rate on the A$42m callable subordinated floating rate notes due 2018 will increase by 0.5% from March 2013.*
3 *The US$450m callable subordinated floating rate notes due 2016 were redeemed in July 2011.*
4 *The interest rate on the US$300m callable subordinated floating rate notes due 2017 will increase by 0.5% from July 2012.*
5 *The interest rate on the 4.35% callable subordinated bonds due 2022 will increase by 1% from June 2017.*
6 *The interest rate on the 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.*

Notes on the Financial Statements (continued)

37 Preference shares

Authorised

At both 31 December 2011 and 31 December 2010, the authorised preference share capital of the Bank was US$13,450,500,000 comprising 3,750,500,000 cumulative redeemable preference shares of US$1 each, 7,500,000,000 non-cumulative irredeemable preference shares of US$1 each and 2,200,000,000 cumulative irredeemable preference shares of US$1 each.

At a group level, there was an additional Rs.900,000,000 (2010: Rs.900,000,000) of authorised preference share capital comprising 9,000,000 compulsorily convertible preference shares of Rs.100 each in the share capital of a subsidiary.

	The group		The Bank	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Issued and fully paid				
Redeemable preference shares	**24,862**	29,153	**24,862**	29,153
Irredeemable preference shares	**68,354**	68,422	**68,227**	68,270
Share premium	**3,880**	3,883	**3,880**	3,883
	97,096	101,458	**96,969**	101,306

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. 1,750,000,000 cumulative redeemable preference shares were issued in 2007, which have mandatory redemption dates between 29 March and 24 November 2017 but may be redeemed at the Bank's option on or after dates starting between 29 March and 24 November 2012, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share.

400,000,000 cumulative redeemable preferences shares were issued 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. 1,050,000,000 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. 550,000,000 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 2011 was 3,200,500,000 (2010: 3,750,500,000). No cumulative redeemable preference shares were issued during the year (2010: nil).

The non-cumulative irredeemable preference shares were issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. 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 2011 was 6,653,000,000 (2010: 6,653,000,000). No non-cumulative irredeemable preference shares were issued during the year (2010: 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 2011 was 2,130,000,000 (2010: 2,130,000,000). No cumulative irredeemable preference shares were issued during the year (2010: nil).

The holders of the preference shares are entitled to one vote per share at shareholder meetings of the Bank.

8,700,000 compulsorily convertible preference shares (CCPS) were issued by HSBC InvestDirect Securities (India) Limited ("HSBC InvestDirect") in 2009 at a nominal value of Rs.100 each. The shares are irredeemable and 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.

38 Share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2011 was HK$50,000m (2010: HK$30,000m) divided into 20,000m (2010: 12,000m) ordinary shares of HK$2.50 each subsequent to the increase in authorised ordinary share capital by the creation of HK$20,000m divided into 8,000m new ordinary shares of HK$2.5 each on 21 December 2011. 3,078,560,000 new ordinary shares were issued during 2011 (2010: nil).

Issued and fully paid

	The group and the Bank	
	2011	2010
	HK$m	HK$m
Ordinary share capital	**30,190**	22,494

	The group and the Bank	
	2011	**2011**
Ordinary shares of HK$2.50 each	**Number**	**HK$m**
At 1 January	**8,997,587,294**	**22,494**
Issued during the year	**3,078,560,000**	**7,696**
At 31 December	**12,076,147,294**	**30,190**

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.

Notes on the Financial Statements (continued)

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. The effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders.

In accordance with updated guidance from the HKMA, the regulatory reserve has been increased to HK$17,108m (31 Dec 2010: HK$7,702m).

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

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
Retirement benefits	–	–	–	–	–	–	111	–	–	111
Other assets	12,288	20,434	15,898	22,152	4,034	8,817	16,581	–	–	100,204
Total assets at 31 December 2011	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 at 31 December 2011	2,926,267	652,300	376,403	226,384	68,918	45,801	347,706	589,095	3,263	5,236,137

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
Retirement benefits	–	–	–	–	–	–	73	–	–	73
Other assets	2,822	11,478	9,417	14,752	3,162	428	14,879	–	–	56,938
Total assets at 31 December 2011	519,871	443,332	465,298	425,758	525,472	344,360	188,796	702,137	317	3,615,341

Notes on the Financial Statements (continued)

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 at 31 December 2011	2,002,523	462,083	190,583	113,825	42,127	41,138	90,280	487,929	1,453	3,431,941

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

The group

2010	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	291,330	284,382	138,644	93,629	–	–	–	–	–	807,985
Items in the course of collection from other banks	–	16,878	–	–	–	–	–	–	–	16,878
Placings with banks maturing after one month	–	–	114,975	27,338	3,800	3,444	–	–	–	149,557
Certificates of deposit	–	7,874	14,583	42,371	5,459	2,917	43	–	–	73,247
Hong Kong Government certificates of indebtedness	148,134	–	–	–	–	–	–	–	–	148,134
Trading assets	–	–	–	–	–	–	–	390,208	–	390,208
Financial assets designated at fair value	–	395	371	1,947	10,625	4,588	36,678	–	–	54,604
Debt securities	–	395	371	1,947	9,994	4,588	4	–	–	17,299
Equity shares	–	–	–	–	–	–	36,674	–	–	36,674
Other	–	–	–	–	631	–	–	–	–	631
Derivatives	–	–	–	–	–	–	–	301,304	1,318	302,622
Loans and advances to customers	112,775	246,351	205,109	312,261	550,396	477,162	(12,994)	–	–	1,891,060
Financial investments	–	40,743	61,393	236,663	323,684	90,122	74,057	–	–	826,662
Debt securities held to maturity	–	279	892	5,868	48,549	66,155	–	–	–	121,743
Debt securities available for sale	–	40,464	60,501	230,795	275,135	23,967	1,222	–	–	632,084
Equity shares available for sale	–	–	–	–	–	–	72,835	–	–	72,835
Amounts due from Group companies	23,727	39,922	8,494	13,577	7,884	3,632	–	40,397	–	137,633
Interests in associates and joint ventures	–	–	–	–	–	–	75,568	–	–	75,568
Goodwill and intangible assets	–	–	–	–	–	–	29,690	–	–	29,690
Property, plant and equipment	–	–	–	–	–	–	72,347	–	–	72,347
Deferred tax assets	–	–	–	–	–	–	2,515	–	–	2,515
Retirement benefits	–	–	–	–	–	–	301	–	–	301
Other assets	3,295	17,093	13,464	12,997	1,680	7,783	4,595	–	–	60,907
Total assets at 31 December 2010	579,261	653,638	557,033	740,783	903,528	589,648	282,800	731,909	1,318	5,039,918

Notes on the Financial Statements (continued)

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

The group

2010	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
Liabilities										
Hong Kong currency notes in circulation	148,134	–	–	–	–	–	–	–	–	148,134
Items in the course of transmission to other banks	–	26,495	–	–	–	–	–	–	–	26,495
Deposits by banks	80,553	79,196	5,694	1,384	699	301	–	–	–	167,827
Customer accounts	2,528,031	384,068	227,183	160,456	13,112	394	–	–	–	3,313,244
Trading liabilities	–	–	–	–	–	–	–	151,534	–	151,534
Financial liabilities designated at fair value	99	–	740	–	5,681	448	33,359	–	–	40,327
Derivatives	–	–	–	–	–	–	–	307,225	2,613	309,838
Debt securities in issue	1,933	15,438	16,902	14,559	5,806	4,645	–	–	–	59,283
Retirement benefit liabilities	–	–	–	–	–	–	4,713	–	–	4,713
Amounts due to Group companies	23,032	15,324	2,118	3,510	7,813	6,168	–	25,163	–	83,128
Other liabilities and provisions	5,121	18,072	24,764	16,020	2,825	196	3,948	–	–	70,946
Liabilities under insurance contracts issued	853	–	–	–	–	–	177,117	–	–	177,970
Current tax liabilities	1	590	650	3,178	–	–	–	–	–	4,419
Deferred tax liabilities	–	–	–	–	–	–	11,913	–	–	11,913
Subordinated liabilities	–	–	–	5,078	4,243	2,529	9,404	–	–	21,254
Preference shares	–	–	–	–	–	33,036	68,422	–	–	101,458
Total liabilities at 31 December 2010	2,787,757	539,183	278,051	204,185	40,179	47,717	308,876	483,922	2,613	4,692,483

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

The Bank

2010	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	201,340	139,998	131,708	77,957	–	–	–	–	–	551,003
Items in the course of collection from other banks	–	12,143	–	–	–	–	–	–	–	12,143
Placings with banks maturing after one month	–	–	52,915	17,816	3,667	393	–	–	–	74,791
Certificates of deposit	–	4,229	7,014	15,243	1,402	–	–	–	–	27,888
Hong Kong Government certificates of indebtedness	148,134	–	–	–	–	–	–	–	–	148,134
Trading assets	–	–	–	–	–	–	–	297,929	–	297,929
Financial assets designated at fair value	–	–	149	233	1,704	–	–	–	–	2,086
Debt securities	–	–	149	233	1,704	–	–	–	–	2,086
Equity shares	–	–	–	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–	–	294,739	740	295,479
Loans and advances to customers	64,594	119,356	109,816	174,537	310,755	246,227	(8,973)	–	–	1,016,312
Financial investments	–	31,135	29,481	169,206	196,586	15,180	62,164	–	–	503,752
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available for sale	–	31,135	29,481	169,206	196,586	15,180	748	–	–	442,336
Equity shares available for sale	–	–	–	–	–	–	61,416	–	–	61,416
Amounts due from Group companies	33,748	54,700	11,981	21,085	16,469	16,999	–	43,340	–	198,322
Investments in subsidiaries	–	–	–	–	–	–	52,924	–	–	52,924
Interests in associates and joint ventures	–	–	–	–	–	–	28,139	–	–	28,139
Goodwill and intangible assets	–	–	–	–	–	–	4,713	–	–	4,713
Property, plant and equipment	–	–	–	–	–	–	45,061	–	–	45,061
Deferred tax assets	–	–	–	–	–	–	1,104	–	–	1,104
Retirement benefits	–	–	–	–	–	–	179	–	–	179
Other assets	1,727	10,685	7,635	6,856	1,030	488	3,452	–	–	31,873
Total assets at 31 December 2010	449,543	372,246	350,699	482,933	531,613	279,287	188,763	636,008	740	3,291,832

Notes on the Financial Statements (continued)

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

The Bank

2010	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
Liabilities										
Hong Kong currency notes in circulation	148,134	–	–	–	–	–	–	–	–	148,134
Items in the course of transmission to other banks	–	17,951	–	–	–	–	–	–	–	17,951
Deposits by banks	59,636	63,872	4,762	1,322	583	301	–	–	–	130,476
Customer accounts	1,635,640	249,273	85,495	65,231	8,693	332	–	–	–	2,044,664
Trading liabilities	–	–	–	–	–	–	–	91,184	–	91,184
Financial liabilities designated at fair value	–	–	740	–	5,681	132	28	–	–	6,581
Derivatives	–	–	–	–	–	–	–	302,365	1,517	303,882
Debt securities in issue	1,933	15,257	13,972	8,789	1,370	1,818	–	–	–	43,139
Retirement benefit liabilities	–	–	–	–	–	–	2,465	–	–	2,465
Amounts due to Group companies	40,794	49,588	15,396	10,172	8,067	6,348	–	15,529	–	145,894
Other liabilities and provisions	2,957	11,287	16,460	8,831	2,124	169	2,204	–	–	44,032
Current tax liabilities	1	336	333	2,016	–	–	–	–	–	2,686
Deferred tax liabilities	–	–	–	–	–	–	5,525	–	–	5,525
Subordinated liabilities	–	–	–	–	–	–	9,404	–	–	9,404
Preference shares	–	–	–	–	–	33,036	68,270	–	–	101,306
Total liabilities at 31 December 2010	1,889,095	407,564	137,158	96,361	26,518	42,136	87,896	409,078	1,517	3,097,323

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 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**
At 31 December 2010						
Hong Kong currency notes in circulation	148,134	–	–	–	–	148,134
Items in the course of transmission to other banks	–	26,495	–	–	–	26,495
Deposits by banks	80,558	84,971	1,399	741	344	168,013
Customer accounts	2,528,174	614,212	165,007	14,834	486	3,322,713
Trading liabilities	151,534	–	–	–	–	151,534
Financial liabilities designated at fair value	99	803	205	6,128	33,795	41,030
Derivatives	307,286	334	953	1,163	124	309,860
Debt securities in issue	1,933	32,676	15,144	6,713	6,382	62,848
Amounts due to Group companies	48,200	17,453	3,532	7,837	6,201	83,223
Other financial liabilities	4,542	38,925	15,034	2,253	191	60,945
Subordinated liabilities	–	211	5,508	6,475	16,078	28,272
Preference shares	–	919	1,499	9,670	122,519	134,607
	3,270,460	816,999	208,281	55,814	186,120	4,537,674
Loan commitments	1,044,586	289,498	25,961	11,050	19	1,371,114
Financial guarantee and credit risk related guarantee contracts	40,752	–	–	–	–	40,752
	4,355,798	1,106,497	234,242	66,864	186,139	5,949,540

Notes on the Financial Statements (continued)

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 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**
At 31 December 2010						
Hong Kong currency notes in circulation	148,134	–	–	–	–	148,134
Items in the course of transmission to other banks	–	17,951	–	–	–	17,951
Deposits by banks	59,640	68,678	1,336	623	344	130,621
Customer accounts	1,635,681	335,626	66,849	9,679	396	2,048,231
Trading liabilities	91,184	–	–	–	–	91,184
Financial liabilities designated at fair value	–	803	205	6,128	148	7,284
Derivatives	302,368	210	583	586	145	303,892
Debt securities in issue	1,933	29,392	8,993	1,541	2,142	44,001
Amounts due to Group companies	56,328	65,001	10,187	8,091	6,404	146,011
Other financial liabilities	2,708	25,256	8,398	1,660	158	38,180
Subordinated liabilities	–	120	205	1,298	12,573	14,196
Preference shares	–	919	1,499	9,670	122,368	134,456
	2,297,976	543,956	98,255	39,276	144,678	3,124,141
Loan commitments	640,773	213,000	7,665	6,537	19	867,994
Financial guarantee and credit risk related guarantee contracts	23,353	–	–	–	–	23,353
	2,962,102	756,956	105,920	45,813	144,697	4,015,488

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.

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

	2011 HK$m	2010 HK$m
Operating profit	**76,287**	66,703
Net interest income	**(75,672)**	(61,876)
Dividend income	**(729)**	(564)
Depreciation and amortisation	**5,638**	5,089
Amortisation of prepaid operating lease payments	**18**	18
Loan impairment charges and other credit risk provisions	**3,059**	4,619
Loans and advances written off net of recoveries	**(4,138)**	(5,557)
Other provisions for liabilities and charges	**723**	161
Provisions utilised	**(276)**	(114)
Surplus arising on property revaluation	**(8)**	(102)
Gains on investment properties	**(1,033)**	(483)
Loss/(Profit) on disposal of property, plant and equipment and assets held for sale	**3**	(13)
Loss/(Profit) on disposal of subsidiaries, associates and business portfolios	**9**	(603)
Gains less losses from financial investments	**(128)**	(2,016)
Share based payments granted cost free	**2,274**	1,427
Interest received	**90,790**	70,449
Interest paid	**(27,458)**	(19,535)
Operating profit before changes in working capital	**69,359**	57,603
Change in treasury bills with original term to maturity of more than three months	**(56,042)**	56,186
Change in placings with banks maturing after one month	**(48,730)**	(42,482)
Change in certificates of deposit with original term to maturity of more than three months	**(15,773)**	(35,189)
Change in trading assets	**(39,833)**	(94,985)
Change in trading liabilities	**19,897**	(2,832)
Change in financial assets designated as fair value	**(3,066)**	(6,517)
Change in financial liabilities designated as fair value	**65**	3,618
Change in derivative assets	**(74,674)**	(67,451)
Change in derivative liabilities	**73,414**	76,992
Change in financial investments held for backing liabilities to long-term policyholders	**(19,813)**	18,682
Change in loans and advances to customers	**(243,760)**	(539,117)
Change in amounts due from Group companies	**(15,097)**	(3,045)
Change in other assets	**(54,932)**	(24,354)
Change in deposits by banks	**54,755**	56,620
Change in customer accounts	**251,757**	368,701
Change in amounts due to Group companies	**22,043**	32,735
Change in debt securities in issue	**18,189**	15,887
Change in liabilities under insurance contracts issued	**31,468**	33,042
Change in other liabilities	**47,405**	(3,465)
Exchange adjustments	**(49)**	(8,553)
Cash generated from/(used in) operations	**16,583**	(107,924)

Notes on the Financial Statements (continued)

43 Analysis of cash and cash equivalents

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

	2011 HK$m	2010 HK$m
Balance at 1 January	**618,199**	675,234
Net cash inflow/(outflow) before the effect of foreign exchange movements	**70,898**	(85,858)
Effect of foreign exchange movements	**(424)**	28,823
Balance at 31 December	**688,673**	618,199

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

	2011 HK$m	2010 HK$m
Cash in hand and sight balances with central banks	**110,107**	81,381
Items in the course of collection from other banks	**34,546**	16,878
Placings with banks	**481,842**	472,774
Treasury bills	**96,443**	60,149
Certificates of deposit	**11,421**	12,331
Other eligible bills	**1,477**	1,181
Less: items in the course of transmission to other banks	**(47,163)**	(26,495)
	688,673	618,199

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

	2011 HK$m	2010 HK$m
Cash consideration	**(187)**	(188)
Cash and cash equivalents acquired	**44**	61
	(143)	(127)

d *Analysis of net inflow/(outflow) of cash and cash equivalents in respect of the sale of subsidiaries*

	2011 HK$m	2010 HK$m
Sale proceeds	**43**	7
Cash and cash equivalents transferred	**(42)**	(20)
	1	(13)

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

	2011 HK$m	2010 HK$m
Sale proceeds	**5,649**	–
Cash and cash equivalents transferred	**–**	–
	5,649	–

44 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	**192,428**	164,145	**128,827**	118,568
Other contingent liabilities	**359**	213	**454**	386
	192,787	164,358	**129,281**	118,954
Commitments				
Documentary credits and short-term trade-related transactions	**44,524**	45,572	**33,233**	33,476
Forward asset purchases and forward forward deposits placed	**2,524**	1,299	**255**	–
Undrawn formal standby facilities, credit lines and other commitments to lend	**1,425,590**	1,324,243	**896,961**	834,518
	1,472,638	1,371,114	**930,449**	867,994

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.

Notes on the Financial Statements (continued)

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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Guarantees in favour of third parties				
Financial guarantee contracts[1]	**26,694**	23,538	**12,904**	12,970
Standby letters of credit which are financial guarantee contracts[2]	**19,684**	17,374	**10,294**	9,960
Other direct credit substitutes[3]	**38,211**	36,798	**32,311**	30,782
Performance bonds[4]	**54,429**	46,116	**39,289**	35,479
Bid bonds[4]	**2,169**	1,911	**1,602**	1,539
Standby letters of credit related to particular transactions[4]	**12,169**	8,653	**7,630**	4,872
Other transaction-related guarantees[4]	**31,892**	25,034	**17,678**	16,636
	185,248	159,424	**121,708**	112,238
Guarantees in favour of other HSBC Group entities	**7,180**	4,721	**7,119**	6,330
	192,428	164,145	**128,827**	118,568

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.

c *Contingencies*

The group is named in and defending legal actions in a number of jurisdictions including Hong Kong, arising out of its normal business operations. None of the actions is regarded as material litigation, and none is expected to result in a significant adverse effect on the financial position of the group, either collectively or individually. Management believes that adequate provisions have been made in respect of such litigation.

45 Assets pledged as security for liabilities and collateral accepted as security for assets

Liabilities of the group amounting to HK$112,721m (2010: HK$64,772m) and of the Bank amounting to HK$70,013m (2010: HK$45,264m) are secured by the deposit of assets, including assets pledged in respect of sale and repurchase agreements, to cover short positions and to facilitate settlement processes with clearing houses. The amount of assets pledged by the group to secure these liabilities is HK$117,963m (2010: HK$73,002m) and by the Bank is HK$74,594m (2010: HK$54,890m). These assets comprise treasury bills, debt securities, equities, and deposits.

In respect of reverse repo and stock borrowing transactions, the fair value of collateral held by the group which was permitted to be sold or repledged amounted to HK$120,319m (2010: HK$151,012m), and by the Bank HK$88,197m (2010: HK$101,438m). The fair value of such collateral actually sold or repledged by the group amounted to HK$14,504m (2010: HK$26,242m) and by the Bank HK$5,980m (2010: HK$7,792m).

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

46 Capital commitments

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**3,511**	1,011	**3,355**	913
Expenditure authorised by the Directors but not contracted for	**6**	42	**2**	–
	3,517	1,053	**3,357**	913

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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**3,734**	2,652	**1,414**	1,446
– five years or less but over one year	**4,603**	4,161	**2,385**	2,067
– over five years	**1,103**	659	**761**	254
	9,440	7,472	**4,560**	3,767
Equipment				
Amounts payable within				
– one year or less	**71**	67	**6**	4
– five years or less but over one year	**100**	113	**9**	2
	171	180	**15**	6

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.

From 1 January 2011 the Asset Management Group, previously reported within GB&M, was combined with the global business previously reported as Personal Financial Services (PFS) to form Retail Banking and Wealth Management ('RBWM'). Global business comparative information has been restated accordingly.

48 Segmental analysis *(continued)*

Total assets

	2011		2010	
	HK$m	**%**	HK$m	%
Hong Kong	**3,594,991**	**64.1**	3,276,432	65.0
Rest of Asia-Pacific	**2,429,228**	**43.3**	2,117,894	42.0
Intra region	**(416,739)**	**(7.4)**	(354,408)	(7.0)
	5,607,480	**100.0**	5,039,918	100.0

Total liabilities

	2011		2010	
	HK$m	**%**	HK$m	%
Hong Kong	**3,436,629**	**65.6**	3,130,937	66.7
Rest of Asia-Pacific	**2,216,247**	**42.3**	1,915,954	40.8
Intra region	**(416,739)**	**(7.9)**	(354,408)	(7.5)
	5,236,137	**100.0**	4,692,483	100.0

Interests in associates and joint ventures

	2011		2010	
	HK$m	**%**	HK$m	%
Hong Kong	**1,525**	**1.7**	1,607	2.1
Rest of Asia-Pacific	**90,260**	**98.3**	73,961	97.9
	91,785	**100.0**	75,568	100.0

Credit commitments (contract amounts)

	2011		2010	
	HK$m	**%**	HK$m	%
Hong Kong	**769,088**	**46.2**	743,732	48.4
Rest of Asia-Pacific	**896,337**	**53.8**	791,740	51.6
	1,665,425	**100.0**	1,535,472	100.0

Property, plant and equipment, goodwill and intangible assets acquired in the year

	2011		2010	
	HK$m	**%**	HK$m	%
Hong Kong	**1,740**	**59.9**	2,590	41.9
Rest of Asia-Pacific	**1,167**	**40.1**	3,596	58.1
	2,907	**100.0**	6,186	100.0

Notes on the Financial Statements (continued)

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
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 policyholders' liabilities	(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)*

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2010				
Interest income	37,687	50,325	(2,489)	85,523
Interest expense	(5,951)	(20,202)	2,506	(23,647)
Net interest income	31,736	30,123	17	61,876
Fee income	24,972	17,628	(943)	41,657
Fee expense	(3,892)	(3,425)	943	(6,374)
Net trading income	8,699	12,034	(17)	20,716
Net income from financial instruments designated at fair value	3,454	303	–	3,757
Gains less losses from financial investments	937	1,079	–	2,016
Dividend income	545	19	–	564
Net earned insurance premiums	33,713	3,480	–	37,193
Other operating income	12,714	2,282	(4,992)	10,004
Total operating income	112,878	63,523	(4,992)	171,409
Net insurance claims incurred and movement in policyholders' liabilities	(37,022)	(2,821)	–	(39,843)
Net operating income before loan impairment charges and other credit risk provisions	75,856	60,702	(4,992)	131,566
Loan impairment charges and other credit risk provisions	(883)	(3,736)	–	(4,619)
Net operating income	74,973	56,966	(4,992)	126,947
Operating expenses	(33,053)	(32,183)	4,992	(60,244)
Operating profit	41,920	24,783	–	66,703
Share of profit in associates and joint ventures	270	10,912	–	11,182
Profit before tax	42,190	35,695	–	77,885
Tax expense	(7,353)	(7,255)	–	(14,608)
Profit for the year	34,837	28,440	–	63,277
Profit attributable to shareholders	30,419	27,178	–	57,597
Profit attributable to non-controlling interests	4,418	1,262	–	5,680
Net operating income				
– external	68,348	57,499	–	125,847
– inter-company/inter-segment	6,625	(533)	(4,992)	1,100
Depreciation and amortisation included in operating expenses	(3,675)	(1,414)	–	(5,089)
Restructuring costs	(86)	(271)	–	(357)

Notes on the Financial Statements (continued)

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 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**
Year ended 31 December 2010							
External	46,254	25,910	51,923	(20)	1,780	–	125,847
Intercompany/intersegment	8,309	2,012	(8,178)	343	5,986	(7,372)	1,100

Information by country

	Net external operating income[1]		Non-current assets[2]	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
Hong Kong	**70,903**	68,348	**91,177**	67,424
Mainland China	**11,952**	6,069	**91,687**	75,410
Australia	**7,115**	6,020	**1,629**	1,652
India	**9,684**	8,445	**2,342**	2,901
Indonesia	**4,715**	4,045	**5,349**	5,532
Malaysia	**7,232**	5,784	**1,033**	982
Singapore	**8,028**	6,774	**1,256**	830
Taiwan	**3,717**	3,165	**2,564**	2,619
Vietnam	**1,606**	1,288	**2,742**	282
Other	**17,039**	15,909	**5,151**	7,476
Total	**141,991**	125,847	**204,930**	165,108

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.*

49 Related party transactions

a *Immediate and ultimate holding company*

The group is controlled by HSBC Asia Holdings BV (incorporated in the Netherlands) which owns 100% of the ordinary shares. The ultimate parent of the group is HSBC Holdings plc (incorporated in England).

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 payment of interest on preference shares. As at 31 December 2011, the Bank has issued HK$96,969m of preference shares to its immediate holding company (2010: HK$101,306m). 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 2011, the Bank has issued HK$9,599m of subordinated liabilities to its ultimate holding company (2010: HK$6,106m). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**2,337**	2,659	**172**	23
Other operating income	**–**	–	**150**	252
Other operating expenses	**30**	28	**1,584**	1,341

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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**167**	319
Amounts due to[2]	**98,243**	102,669	**9,990**	6,351

The Bank

	Immediate holding company		Ultimate holding company	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**167**	319
Amounts due to[2]	**98,243**	102,669	**9,916**	6,287

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$96,969m (2010: HK$101,306m). Amounts due to the ultimate holding company included subordinated liabilities of HK$9,599m (2010: HK$6,106m).*

Guarantees made by the ultimate holding company to and on behalf of the group amounted to HK$283m (2010: HK$353m).

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 Holdings plc whereby share options or shares of HSBC Holdings plc 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 these share options and share awards is treated as a capital contribution and is recorded under 'Other reserves'. In respect of share awards, the group recognises a liability due to the ultimate holding company and a corresponding reduction in capital contribution on a straight-line basis over the vesting period for the amount of share awards expected to vest. The liability is measured at the fair value of the shares at each reporting date. The balances of the capital contribution and the liability as at 31 December 2011 amounted to HK$2,915m and HK$2,729m respectively (2010: HK$2,223m and HK$1,812m respectively).

c *Pension funds*

At 31 December 2011, HK$12.5bn (2010: HK$13.4bn) 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$53m for the year (2010: HK$49m).

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 shared certain IT projects with its fellow subsidiaries and also used certain processing services of fellow subsidiaries on a cost recovery basis. The Bank also acted as agent for the distribution of retail investment funds for fellow subsidiaries and paid professional service fees on certain structured finance deals to a fellow subsidiary. The commissions and fees in these transactions are priced on an 'arm's length' basis.

The aggregate amount of income and expenses arising from these transactions during the year and the balances of amounts due to and from the relevant parties at the year end are as follows:

Income and expenses for the year

	Fellow subsidiaries	
	2011	2010
	HK$m	HK$m
Interest income	**445**	547
Interest expense	**797**	488
Fee income	**2,470**	1,969
Fee expense	**935**	1,065
Other operating income	**3,227**	2,576
Other operating expenses[1]	**5,169**	4,002

1 *In 2011 payments were made of HK$1,271m (2010: HK$922m) for software costs which were capitalised as intangible assets in the balance sheet of the group.*

49 Related party transactions *(continued)*

Balances at 31 December

The group

	Fellow subsidiaries	
	2011	2010
	HK$m	HK$m
Assets		
Trading assets	**11,120**	40,396
Financial assets designated at fair value	**5,390**	5,453
Other assets	**136,051**	91,465
	152,561	137,314
Liabilities		
Trading liabilities	**37,675**	25,164
Financial liabilities designated at fair value	**5**	3
Other liabilities	**59,605**	50,399
	97,285	75,566
Guarantees	**7,180**	4,721
Commitments	**6,689**	17,615

The Bank

	Subsidiaries		Fellow subsidiaries	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Trading assets	**3,486**	4,549	**10,970**	38,792
Financial assets designated at fair value	**–**	–	**–**	–
Other assets	**113,761**	77,244	**119,616**	77,418
	117,247	81,793	**130,586**	116,210
Liabilities				
Trading liabilities	**7,421**	8,165	**25,837**	7,364
Financial liabilities designated at fair value	**–**	–	**–**	–
Other liabilities	**54,655**	77,571	**53,803**	45,144
	62,076	85,736	**79,640**	52,508
Guarantees	**1,039**	2,507	**6,080**	3,823
Commitments	**38,484**	24,334	**3,639**	15,363

Notes on the Financial Statements (continued)

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

	2011		2010	
	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**	31	31
– unsubordinated	**23,418**	**19,183**	16,312	12,930
Amounts due from joint ventures				
– subordinated	**13**	**6**	8	8
– unsubordinated	**1,107**	**966**	1,493	699
	24,572	**20,188**	17,844	13,668
Amounts due to associates	**4,536**	**3,672**	5,329	4,077
Amounts due to joint ventures	**1,488**	**1,013**	1,140	1,013
	6,024	**4,685**	6,469	5,090
Commitments	**1,431**	**711**	470	337

The Bank

	2011		2010	
	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	**7,509**	**3,825**	7,045	4,513
Amounts due from joint ventures				
– unsubordinated	**881**	**876**	1,293	608
	8,390	**4,701**	8,338	5,121
Amounts due to associates	**1,065**	**1,065**	1,158	738
Amounts due to joint ventures	**1,486**	**1,011**	1,139	1,013
	2,551	**2,076**	2,297	1,751
Commitments	**1,012**	**351**	226	226

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.

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:

	2011 HK$m	2010 HK$m
Salaries and other short term benefits	**220**	207
Retirement benefits		
– Defined contribution plans	**8**	12
– Defined benefit plans	**2**	1
Share-based payments	**110**	118
	340	338

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:

	2011 HK$m	2010 HK$m
For the year		
Average assets	**22,177**	17,282
Average liabilities	**27,536**	24,206
Contribution to the group's profit before tax	**818**	439
At the year end		
Guarantees	**3,874**	2,487
Commitments	**6,417**	5,842

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.

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:

	Aggregate amount of loans outstanding at 31 December		Maximum aggregate amount of loans outstanding during the year	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
By the Bank	**73**	70	**83**	117
By subsidiaries	**13**	4	**15**	22
	86	74	**98**	139

Notes on the Financial Statements (continued)

50 Share-based payments

a *Income statement charge*

	2011 HK$m	2010 HK$m
Restricted share awards	**1,907**	1,044
Performance share awards	**17**	8
Savings-related share option plans	**350**	375
	2,274	1,427
Equity-settled share-based payments	**2,274**	1,427
Cash-settled share-based payments	**–**	–

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.

HSBC Share Awards

Award	Policy	Purpose
Restricted share awards	• Vesting of awards based on continued employment with HSBC of between one and five years from the date of award • Shares awarded without corporate performance conditions • Certain shares awarded subject to a retention requirement until cessation of employment	• Rewards employee performance, potential and retention requirements • To aid recruitment • Part-deferral of annual bonuses
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

b *Movement on HSBC share awards*

The group	Restricted share awards		Performance share awards[1]		Achievement share awards[1]	
	2011 Number (000s)	2010 Number (000s)	**2011 Number (000s)**	2010 Number (000s)	**2011 Number (000s)**	2010 Number (000s)
Outstanding at 1 January	**38,476**	21,759	**283**	676	**2,911**	5,203
Additions during the year	**17,380**	23,912	**10**	17	**33**	123
Released in the year	**(4,674)**	(4,554)	**(61)**	(140)	**(2,886)**	(2,103)
Transferred in the year	**744**	340	**–**	(37)	**(12)**	(50)
Lapsed in the year	**(1,701)**	(2,981)	**(232)**	(233)	**(46)**	(262)
Outstanding at 31 December	**50,225**	38,476	**–**	283	**–**	2,911
Weighted average remaining vesting period (years)	**0.68**	1.30	**–**	0.23	**–**	0.25

1 *Additions during the year comprised reinvested dividend equivalents.*

50 Share-based payments *(continued)*

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% (2010: 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 the next page 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.

c *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
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**
2010			
Risk-free interest rate[1] (%)	0.7	1.9	2.9
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	30	30	30
Share price at grant date (£)	6.82	6.82	6.82

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 4.5% per annum in line with consensus analyst forecasts (2010: 4.5%) which vested in subsequent years.

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

d *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$
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**
2010						
Outstanding at 1 January	22,379	7.03	16,151	3.67	48,513	38.49
Granted during the year	–	–	3,755	5.46	4,796	62.98
Forfeited/expired in the year	(1,305)	6.89	(1,734)	4.32	(3,116)	44.10
Exercised during the year	(1,226)	6.43	(2,859)	3.91	(4,847)	38.26
Transferred in the year	47	6.92	91	3.87	(40)	49.10
Outstanding at 31 December	19,895	7.07	15,404	3.99	45,306	40.72
Exercisable at 31 December	19,895	7.07	233	6.09	69	94.51
At 31 December 2010						
Weighted average fair value of options granted during the year		–		1.48		19.02
Weighted average share price at the date the options were exercised		6.65		6.53		79.38
Weighted average remaining contractual life (years)		2.15		2.45		2.89
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 utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, inter alia:

- the extent to which prices may be expected to represent genuine traded or 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. 'Not observable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (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

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.

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(b).

51 Fair value of financial instruments *(continued)*

Credit risk adjustment methodology

A separate credit risk adjustment is calculated for each legal entity of the group, and within each entity for each counterparty to which the entity has exposure. The calculation of the monoline credit risk adjustment and sensitivity to different assumptions is described below. The credit risk adjustment is calculated by applying the probability of default of the counterparty to the expected positive exposure to the counterparty, and multiplying the result by the loss expected in the event of default. The calculation is performed over the life of the potential exposure.

The probability of default is 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 through the use of historic rating transition matrices. For most products, to calculate the expected positive exposure to a counterparty, a simulation methodology is used 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. The group does not adjust derivative liabilities for the group's own credit risk; such an adjustment is often referred to as a 'debit valuation adjustment'.

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.

All third party counterparties are included in the credit risk adjustment calculation and credit risk adjustments are not netted across group entities.

During 2011, no material changes were made to the methodologies used to calculate the credit risk adjustment.

Fair value valuation bases

The approach used to calculate the fair value of each type of financial instrument is as follows:

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.

51 Fair value of financial instruments *(continued)*

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 ABSs including residential MBSs, 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 valuations output is benchmarked for consistency against observable data for securities of a similar nature.

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.

Structured notes

The fair value of structured notes valued using a valuation technique is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative is determined as described in the paragraph below on derivatives.

Trading liabilities valued using a valuation technique with significant unobservable inputs principally comprised equity-linked structured notes, which are issued by the group and provide the counterparty with a return that is linked to the performance of certain equity securities, and other portfolios. The notes are classified as level 3 due to the unobservability of parameters such as long-dated equity volatilities and correlations between equity prices, between equity prices and interest rates and between interest rates and foreign exchange rates.

Derivatives

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.

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

		Valuation techniques				
	Quoted market price Level 1 HK$m	using observable inputs Level 2 HK$m	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 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**
At 31 December 2010						
Assets						
Trading assets	263,579	124,594	2,035	390,208	–	390,208
Financial assets designated at fair value	38,300	13,867	2,437	54,604	–	54,604
Derivatives	2,533	236,479	1,372	240,384	62,238	302,622
Available-for-sale investments[1]	494,178	534,623	22,155	1,050,956	–	1,050,956
Liabilities						
Trading liabilities	56,846	80,174	14,514	151,534	–	151,534
Financial liabilities designated at fair value	–	40,327	–	40,327	–	40,327
Derivatives	2,617	234,996	1,612	239,225	70,613	309,838

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 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**
At 31 December 2010						
Assets						
Trading assets	230,705	65,256	1,968	297,929	–	297,929
Financial assets designated at fair value	–	1,974	112	2,086	–	2,086
Derivatives	1,753	227,519	1,075	230,347	65,132	295,479
Available-for-sale investments[1]	449,296	317,363	17,708	784,367	–	784,367
Liabilities						
Trading liabilities	37,123	46,270	7,791	91,184	–	91,184
Financial liabilities designated at fair value	–	6,581	–	6,581	–	6,581
Derivatives	2,332	226,901	1,495	230,728	73,154	303,882

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	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m
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)**
At 1 January 2010	24,161	2,591	5,890	1,891	11,357	–	2,981
Total gains or losses recognised in profit or loss	308	371	492	184	35	–	(192)
Total gains or losses recognised in other comprehensive income	1,878	15	12	34	506	–	16
Purchases	3,367	279	460	–	–	–	–
Issues	–	–	–	–	2,827	–	–
Sales	(1,347)	(2,045)	(216)	–	–	–	–
Deposits / settlements	(539)	475	(170)	1,421	127	–	772
Transfers out	(17,961)	(2,171)	(5,423)	(2,462)	(2,952)	–	(2,351)
Transfers in	12,288	2,520	1,392	304	2,614	–	386
At 31 December 2010	22,155	2,035	2,437	1,372	14,514	–	1,612
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	63	58	190	97	(114)	–	(78)

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	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m
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)**
At 1 January 2010	21,711	1,733	167	1,759	4,859	–	2,911
Total gains or losses recognised in profit or loss	640	2	21	77	119	–	(300)
Total gains or losses recognised in other comprehensive income	1,025	13	–	33	93	–	15
Purchases	2,959	278	–	–	–	–	–
Issues	–	–	–	–	2,220	–	–
Sales	(1,338)	(1,445)	–	–	–	–	–
Deposits / settlements	(241)	475	–	1,283	708	–	786
Transfers out	(16,800)	(1,542)	(76)	(2,381)	(862)	–	(2,303)
Transfers in	9,752	2,454	–	304	654	–	386
At 31 December 2010	17,708	1,968	112	1,075	7,791	–	1,495
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	140	58	21	52	(60)	–	34

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.*

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

For available-for sale securities and assets held for trading, 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 also occurred in respect of certain debt securities as valuations of these assets became unobservable during the year.

For assets designated at fair value through profit or loss, the observability of valuations of certain debt securities and equity shares 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, increase in the observability of interest rate basis spreads and equity volatilities during the year resulted in transfers out of level 3. In addition, the unobservability of credit default swaps resulted in derivative assets and liabilities being transferred into level 3.

For held-for-trading liabilities, transfers into level 3 were primarily due to a reduction in the observability of volatilities. 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 (expense) / income 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 value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions.

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 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)**
At 31 December 2010				
Derivatives/trading assets/trading liabilities	492	(494)	–	–
Financial assets/liabilities designated at fair value	234	(234)	–	–
Financial investments: available-for-sale	–	–	2,073	(2,073)

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 2011				
Derivatives/trading assets/trading liabilities	**223**	**(153)**	**–**	**–**
Financial assets/liabilities designated at fair value	**–**	**–**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**1,232**	**(1,232)**
At 31 December 2010				
Derivatives/trading assets/trading liabilities	444	(445)	–	–
Financial assets/liabilities designated at fair value	2	(2)	–	–
Financial investments: available-for-sale	–	–	1,632	(1,632)

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	
	2011 HK$m	2010 HK$m	**2011 HK$m**	2010 HK$m
At 31 December				
Derivatives/trading assets/trading liabilities	**(369)**	(37)	**(173)**	84
Financial assets/liabilities designated at fair value	**60**	190	**–**	21

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 2011		31 December 2010	
	Carrying value	**Fair value**	Carrying value	Fair value
	HK$m	**HK$m**	HK$m	HK$m
Assets				
Placings with banks	**654,581**	**654,756**	597,081	597,144
Loans and advances to customers	**2,130,871**	**2,101,243**	1,891,060	1,889,974
Debt securities	**143,062**	**151,363**	128,033	132,832
Liabilities				
Deposits by banks	**222,582**	**222,697**	167,827	167,832
Customer accounts	**3,565,001**	**3,565,036**	3,313,244	3,313,148
Debt securities in issue	**77,472**	**77,330**	59,283	59,343
Subordinated liabilities	**16,114**	**14,157**	21,254	19,771
Preference shares	**97,096**	**86,932**	101,458	93,232

The Bank

	31 December 2011		31 December 2010	
	Carrying value	**Fair value**	Carrying value	Fair value
	HK$m	**HK$m**	HK$m	HK$m
Assets				
Placings with banks	**341,527**	**341,970**	318,912	318,983
Loans and advances to customers	**1,176,602**	**1,159,635**	1,016,312	1,015,787
Liabilities				
Deposits by banks	**158,746**	**158,743**	130,476	130,475
Customer accounts	**2,220,072**	**2,220,031**	2,044,664	2,044,807
Debt securities in issue	**46,360**	**46,245**	43,139	43,160
Subordinated liabilities	**9,386**	**7,354**	9,404	7,992
Preference shares	**96,969**	**86,805**	101,306	93,081

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 of 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.

52 Risk Management

The group's activities involve the analysis, evaluation, acceptance and management of financial risks. The principal financial risks are:

- credit risk;
- liquidity risk;
- market risk (including foreign exchange, interest rate and equity price risks);
- operational risk;
- 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 off-balance sheet products such as guarantees and derivatives, 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.

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 Audit and Risk Committee ('ARC') also has responsibility for oversight and advice to the Board on risk matters. The key responsibilities of the ARC 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 ARC 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 ARC 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

	2011 HK$m	2010 HK$m
Cash and short-term funds	**919,906**	807,985
Items in the course of collection from other banks	**34,546**	16,878
Placings with banks maturing after one month	**198,287**	149,557
Certificates of deposit	**88,691**	73,247
Hong Kong Government certificates of indebtedness	**162,524**	148,134
Trading assets	**432,908**	372,410
Debt securities	**168,849**	200,379
Treasury bills and other eligible bills	**230,959**	140,873
Other	**33,100**	31,158
Financial assets designated at fair value	**17,402**	17,930
Debt securities	**16,762**	17,299
Other	**640**	631
Derivatives	**377,296**	302,622
Loans and advances to customers	**2,130,871**	1,891,060
Financial investments: Debt securities	**677,256**	753,827
Amounts due from Group companies	**152,730**	137,633
Other assets	**77,521**	56,452
Acceptances and endorsements	**31,750**	25,892
Other	**45,771**	30,560
Financial guarantees and other credit-related contingent liabilities	**48,432**	40,752
Loan commitments and other credit-related commitments	**1,683,589**	1,543,697
At 31 December	**7,001,959**	6,312,184

The Bank

	2011 HK$m	2010 HK$m
Cash and short-term funds	**612,265**	551,003
Items in the course of collection from other banks	**29,821**	12,143
Placings with banks maturing after one month	**108,873**	74,791
Certificates of deposit	**23,987**	27,888
Hong Kong Government certificates of indebtedness	**162,524**	148,134
Trading assets	**302,343**	280,309
Debt securities	**120,575**	155,174
Treasury bills and other eligible bills	**160,911**	112,602
Other	**20,857**	12,533
Financial assets designated at fair value: debt securities	**2,283**	2,086
Derivatives	**370,678**	295,479
Loans and advances to customers	**1,176,602**	1,016,312
Financial investments: Debt securities	**325,136**	442,336
Amounts due from group companies	**248,001**	198,322
Other assets	**43,059**	28,980
Acceptances and endorsements	**21,001**	17,041
Other	**22,058**	11,939
Financial guarantees and other credit-related contingent liabilities	**25,448**	23,353
Loan commitments and other credit-related commitments	**1,067,049**	948,987
At 31 December	**4,498,069**	4,050,123

52 Risk Management *(continued)*

(ii) 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 utilise 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.

Personal lending

Residential mortgages including loan commitments by level of collateral

	2011	2010
	HK$m	HK$m
Not collateralised	**1,290**	896
Fully collateralised	**659,976**	611,137
– Less than 25% LTV	**60,167**	53,608
– 25% to 50% LTV	**230,027**	192,134
– 51% to 75% LTV	**278,216**	275,830
– 76% to 90% LTV	**81,597**	79,525
– 91% to 100% LTV	**9,969**	10,040
Partially collateralised		
– Greater than 100% LTV	**4,156**	605
– Collateral value	**3,912**	461
Total residential mortgages	**665,422**	612,638

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.

52 Risk Management *(continued)*

Other personal lending

Other personal lending consists primarily of personal loans, overdrafts and credit cards, all of which are generally unsecured.

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

	2011 HK$m	2010 HK$m
Rated CRR/EL 1 to 7	**280,706**	266,548
Not collateralised	**120,602**	103,321
Fully collateralised	**144,975**	149,236
Partially collateralised (A)	**15,129**	13,991
– collateral value on A	**6,770**	8,382
Rated CRR/EL 8 to 10	**616**	899
Not collateralised	**95**	67
Fully collateralised	**193**	337
Partially collateralised (B)	**328**	495
– collateral value on B	**203**	345
Total commercial real estate loans and advances	**281,322**	267,447

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 including loan commitments by level of collateral

	2011	2010
	HK$m	HK$m
Rated CRR/EL 8 to 10	**12,501**	15,006
Not collateralised	**8,882**	11,053
Fully collateralised	**1,634**	1,498
Partially collateralised (A)	**1,985**	2,455
– collateral value on A	**1,015**	1,246

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

	2011	2010
	HK$m	HK$m
Not collateralised	**615,783**	541,913
Fully collateralised	**64,411**	75,494
Partially collateralised (A)	**3,847**	218
– collateral value on A	**1,996**	184
Total loans and advances to banks	**684,041**	617,625

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 collateralised.

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 institutional 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'.

52 Risk Management *(continued)*

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	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**103**	37	**35**	4
Commercial and industrial properties	**6**	12	**–**	2
Other assets	**3**	2	**–**	–
	112	51	**35**	6

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.

(iii) 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 disclosure 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.*

52 Risk Management *(continued)*

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 disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ('Expected Loss') grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

  The group's policy in respect of impairment on loans and advances and debt securities is set out in notes 3(d) and 3(g) on the Financial Statements. Analysis of impairment allowances as at 31 December 2011 and the movement of such allowances during the year are disclosed in note 19.

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.

52 Risk Management *(continued)*

(iv) Distribution of financial instruments by credit quality

The group

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	**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.*

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

31 December 2010	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	15,294	1,584	–	–	–	–	16,878
Trading assets	319,851	51,858	701	–	–	–	372,410
– treasury and other eligible bills	133,799	7,074	–	–	–	–	140,873
– debt securities	160,916	39,306	157	–	–	–	200,379
– loans and advances to banks	24,140	1,509	471	–	–	–	26,120
– loans and advances to customers	996	3,969	73	–	–	–	5,038
Financial assets designated at fair value	15,994	1,936	–	–	–	–	17,930
– debt securities	15,363	1,936	–	–	–	–	17,299
– loans and advances to customers	631	–	–	–	–	–	631
Derivatives	264,605	37,114	903	–	–	–	302,622
Loans and advances held at amortised cost	1,577,126	847,090	35,382	25,256	16,281	(12,994)	2,488,141
– loans and advances to banks	537,729	56,777	1,739	836	–	–	597,081
– loans and advances to customers	1,039,397	790,313	33,643	24,420	16,281	(12,994)	1,891,060
Financial investments	1,017,926	87,053	993	121	61	–	1,106,154
– treasury and other eligible bills	259,134	19,946	–	–	–	–	279,080
– debt securities[2]	758,792	67,107	993	121	61	–	827,074
Other assets	18,565	36,409	903	501	74	–	56,452
– endorsements and acceptances	6,481	18,617	694	41	59	–	25,892
– other	12,084	17,792	209	460	15	–	30,560
Total	3,229,361	1,063,044	38,882	25,878	16,416	(12,994)	4,360,587

1 *Includes HK$78,778m 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$26m of impaired debt securities overdue for between 6 months and 1 year.*

52 Risk Management *(continued)*

The Bank

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	**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.*

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

31 December 2010	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	10,649	1,494	–	–	–	–	12,143
Trading assets	235,598	44,010	701	–	–	–	280,309
– treasury and other eligible bills	105,596	7,006	–	–	–	–	112,602
– debt securities	122,531	32,486	157	–	–	–	155,174
– loans and advances to banks	6,500	1,509	471	–	–	–	8,480
– loans and advances to customers	971	3,009	73	–	–	–	4,053
Financial assets designated at fair value: debt securities	863	1,223	–	–	–	–	2,086
Derivatives	260,596	34,171	712	–	–	–	295,479
Loans and advances held at amortised cost	858,392	449,484	14,290	11,435	10,596	(8,973)	1,335,224
– loans and advances to banks	296,100	21,119	860	833	–	–	318,912
– loans and advances to customers	562,292	428,365	13,430	10,602	10,596	(8,973)	1,016,312
Financial investments	647,365	74,411	993	121	61	–	722,951
– treasury and other eligible bills	234,567	18,160	–	–	–	–	252,727
– debt securities	412,798	56,251	993	121	61	–	470,224
Other assets	9,563	18,495	796	58	68	–	28,980
– endorsements and acceptances	4,478	11,831	632	41	59	–	17,041
– other	5,085	6,664	164	17	9	–	11,939
Total	2,023,026	623,288	17,492	11,614	10,725	(8,973)	2,677,172

1 *Includes HK$72,641m 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 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 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**
31 December 2010						
Loans and advances held at amortised cost	20,264	3,305	1,324	298	65	25,256
– loans and advances to banks	836	–	–	–	–	836
– loans and advances to customers[1]	19,428	3,305	1,324	298	65	24,420
Financial investments	121	–	–	–	–	121
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	121	–	–	–	–	121
Other assets	144	111	123	57	66	501
	20,529	3,416	1,447	355	131	25,878

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 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**
31 December 2010						
Loans and advances held at amortised cost	9,341	1,386	586	107	15	11,435
– loans and advances to banks	833	–	–	–	–	833
– loans and advances to customers[1]	8,508	1,386	586	107	15	10,602
Financial investments	121	–	–	–	–	121
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	121	–	–	–	–	121
Other assets	52	4	1	–	1	58
	9,514	1,390	587	107	16	11,614

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 2011, and the movement of such allowances during the year, are disclosed in note 19.

b *Liquidity risk*

Liquidity relates to the ability of a company to meet its obligations as they fall due. The group maintains a stable and diversified funding base of core retail and corporate customer deposits as well as portfolios of highly liquid assets. The objective of the group's liquidity and funding management is to ensure that all foreseeable funding commitments and deposit withdrawals can be met when due.

Liquidity risk is the risk that we do not have sufficient financial resources to meet our obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.

The objective of our liquidity and funding management framework is to ensure that all foreseeable funding commitments can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. To this end, we maintain a diversified funding base comprising core retail and corporate customer deposits and institutional balances. We augment this with wholesale funding and portfolios of highly liquid assets diversified by currency and maturity which are held to enable us to respond quickly and smoothly to unforeseen liquidity requirements.

Operating entities are required to maintain strong liquidity positions and to manage the liquidity profiles of their assets, liabilities and commitments with the objective of ensuring that their cash flows are balanced appropriately and that all their anticipated obligations can be met when due.

We adapt our liquidity and funding risk management framework in response to changes in the mix of business that we undertake, and to changes in the nature of the markets in which we operate. We also continuously seek to evolve and strengthen our liquidity and funding risk management framework.

It is the responsibility of local management to ensure compliance with local regulatory requirements and limits set by the HSBC Group/regional head office. Liquidity is managed on a daily basis by local treasury functions, with the larger treasury sites providing support to smaller entities where required.

Compliance with liquidity and funding requirements is monitored by local Asset and Liability Management Committees ('ALCO') which report to the group's Head Office on a regular basis. This process includes:

- 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.

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.

A maturity analysis of assets and liabilities is disclosed in note 40, while an analysis of possible cash flows under contractual terms is disclosed in note 41.

We use a number of principal measures to manage liquidity risk, as described below.

Inherent liquidity risk categorisation

We categorise our operating entities into one of three categories to reflect our assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the operating entities' host country, and also factors specific to the entity itself, such as the local footprint, market share, balance sheet strength and control framework. This assessment is used to determine the severity of the liquidity stress that we expect our operating entities to be able to withstand, as expressed in our principal liquidity risk metrics, being the stressed one month coverage ratio and the advances to core funding ratio.

Core deposits

Our internal framework is based on our categorisation of customer deposits into core and non-core. This characterisation takes into account the inherent liquidity risk categorisation of the entity originating the deposit, the nature of the customer and the size and pricing of the deposit.

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 discourages reliance on short-term professional funding. This is achieved by placing limits on banking entities which restrict their ability to increase loans and advances to customers without a corresponding growth in core customer deposits or long term debt funding, this measure is referred to as the 'advances to core funding' ratio.

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. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio.

Projected cash flow scenario analysis

The group uses a number of standard projected cash flow scenarios designed to model both group-specific and market-wide liquidity crises, in which the rate and timing of deposit withdrawals and drawdowns on committed lending facilities are varied, and the ability to access interbank funding and term debt markets and to generate funds from asset portfolios is restricted. The scenarios are modelled by all group banking entities. The appropriateness of the assumptions under each scenario is regularly reviewed. In addition to the group's standard projected cash flows scenarios, individual entities are required to design their own scenarios to reflect specific local market conditions, products and funding bases.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Stressed one month coverage ratio

The stressed one month coverage ratios tabulated below are derived from projected cash flow scenario analyses, and express the stressed cash inflows as a percentage of stressed cash outflows over a one month time horizon. Group sites are required to target a ratio of 100% or greater.

Advances to core funding ratios and the stressed one 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	
	2011	2010	**2011**	2010
	%	%	**%**	%
Year-end	**75.0**	70.3	**122.9**	144.6
Maximum	**78.9**	70.3	**144.6**	165.4
Minimum	**70.3**	55.5	**116.4**	132.6
Average	**75.9**	63.6	**124.0**	148.8

Liquidity behaviouralisation will be applied to reflect our conservative 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 conservatively assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour.

Contingent liquidity risk

In the normal course of business, group entities provide customers with committed and standby facilities. These facilities increase the funding requirements of the group when customers choose to raise drawdown levels over and above their normal utilisation rates. The liquidity risk consequences of increased levels of drawdown are analysed in the form of projected cash flows under different stress scenarios. Limits are set for non-cancellable contingent funding commitments by the group after due consideration of each entity's ability to fund them. The limits are split according to the borrower and the size of the committed line.

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.

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.

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

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 was as follows:

	The group		The Bank	
	2011	2010	**2011**	2010
	HK$m	HK$m	**HK$m**	HK$m
Total VAR				
Year end	**393**	433	**279**	331
Average	**306**	466	**235**	377
Maximum	**463**	596	**326**	528
Minimum	**190**	271	**156**	230
Total interest rate VAR				
Year end	**151**	174	**105**	158
Average	**141**	264	**121**	249
Maximum	**187**	350	**161**	332
Minimum	**108**	139	**92**	144
Total foreign exchange VAR				
Year end	**49**	68	**51**	58
Average	**50**	44	**52**	45
Maximum	**116**	116	**111**	115
Minimum	**28**	19	**29**	15
Total credit spread VAR[2]				
Year end	**343**	264	**196**	173
Average	**246**	335	**166**	245
Maximum	**380**	464	**247**	347
Minimum	**136**	188	**96**	149
Total trading VAR				
Year end	**184**	136	**156**	122
Average	**131**	169	**118**	170
Maximum	**208**	255	**184**	242
Minimum	**73**	84	**69**	76
Interest rate trading VAR				
Year end	**98**	79	**101**	68
Average	**91**	148	**87**	150
Maximum	**150**	208	**120**	227
Minimum	**62**	76	**59**	67
Foreign exchange trading VAR				
Year end	**46**	64	**48**	53
Average	**47**	41	**47**	43
Maximum	**99**	118	**95**	122
Minimum	**24**	15	**27**	14
Credit spread trading VAR				
Year end	**109**	47	**82**	42
Average	**67**	66	**57**	62
Maximum	**115**	103	**96**	97
Minimum	**36**	39	**32**	37
Equity trading VAR[1]				
Year end	**15**	9	**15**	9
Average	**18**	15	**18**	15
Maximum	**37**	45	**37**	45
Minimum	**5**	3	**5**	3

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 2011, a 10% decrease in equity prices would reduce profit before tax and net assets by HK$186m (2010: HK$119m) and a 100 basis points decrease in interest rates would reduce profit before tax and net assets by HK$156m (2010: HK$27m).*

2 *Total credit spread VAR includes credit spread VAR for the accrual book from March 2010 onwards.*

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$267,382m (78% of shareholders' funds) at 31 December 2011, a decrease of HK$5,501m from HK$272,883m (85% of shareholders' funds) at 31 December 2010. 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 2011				
Chinese renminbi	**117,895**	**145,347**	**32,290**	**39,809**
At 31 December 2010				
Chinese renminbi	122,017	143,909	52,598	62,035
Indian rupees	179,314	31,178	127,064	22,093

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*

The group is exposed to the uncertainty surrounding the timing and severity of claims under insurance contracts. 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 a claim can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities. 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.

All insurance products, whether internally manufactured or provided by a third party manufacturer, are reviewed by the Product and Pricing 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, random, 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 with minimum volatility. The Asset and Liability Management Committee reviews and approves target portfolios on a periodic basis, establishes investment guidelines and limits, and provides oversight of the asset and liability management process.

The group establishes target asset portfolios for each major insurance product category consistent with local regulatory requirements. The investment strategy and asset allocations consider yield, duration, sensitivity, market risk, volatility, liquidity, asset concentration, foreign exchange and credit quality.

The following table shows the composition of assets and liabilities for each major insurance product category. 92% of both assets and liabilities are derived from Hong Kong.

Statement of financial position of insurance 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 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 contacts	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

	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 2010					
Financial assets:					
– financial assets designated at fair value	28,652	21,753	417	917	51,739
– derivatives	–	474	3	3	480
– financial investments	–	127,213	1,280	7,896	136,389
– other financial assets	2,296	24,132	1,369	705	28,502
Total financial assets	30,948	173,572	3,069	9,521	217,110
Reinsurance assets	5,567	161	420	89	6,237
PVIF[4]	–	–	–	14,767	14,767
Other assets	4	1,923	190	3,766	5,883
Total assets	36,519	175,656	3,679	28,143	243,997
Liabilities under investment contracts designated at fair value	7,478	26,268	–	–	33,746
Liabilities under insurance contacts	28,920	146,130	2,920	–	177,970
Deferred tax	–	121	1	2,497	2,619
Other liabilities	–	–	–	2,705	2,705
Total liabilities	36,398	172,519	2,921	5,202	217,040
Total equity	–	–	–	26,957	26,957
Total equity and liabilities	36,398	172,519	2,921	32,159	243,997

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 outcome.

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 retained sum assured so that it falls within the specified insurance risk appetite. The group also utilises reinsurance to manage financial risk arising from guaranteeing minimum investment performance under a specific unit-linked insurance product, and uses reinsurance agreements with non-affiliated reinsurers to manage its exposure to losses resulting from certain catastrophes.

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

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, underwriting guidelines, reinsurance and centralised management of reinsurance and monitoring of emerging issues.

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, where the majority is Hong Kong.

52 Risk Management *(continued)*

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 181.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies 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. By definition, the group is not exposed to insurance risk on investment contracts, so they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 34. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

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

	2011 **HK$m**	2010 HK$m
Accident and health	**1,504**	1,411
Fire and other damage	**307**	306
Motor	**325**	332
Liability	**164**	180
Marine, aviation and transport	**105**	111
Other (non-life)	**458**	369
Total net written insurance premiums	**2,863**	2,709

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

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 underwriting subsidiaries at 31 December 2011 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 operations

	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**

	At 31 December 2010				
	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	506	13,226	417	917	15,066
– Equity securities	28,146	8,527	–	–	36,673
	28,652	21,753	417	917	51,739
Financial investments					
Held-to-maturity:					
– Debt securities	–	119,791	1,186	7,057	128,034
Available-for-sale:					
– Treasury bills	–	–	–	–	–
– Debt securities	–	7,418	94	808	8,320
– Equity securities	–	4	–	31	35
	–	7,422	94	839	8,355
Derivatives	–	474	3	3	480
Other financial assets	2,296	24,132	1,369	705	28,502
	30,948	173,572	3,069	9,521	217,110

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 12.1% of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2011 (2010: 14.3%). The table also shows that approximately 69.3% of financial assets were invested in debt securities at 31 December 2011 (2010: 69.7%) with 16.1% (2010: 16.9%) invested in equity securities.

Market risk

Market risk can be sub-categorised into interest rate risk, equity risk 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 related to non-linked policies 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 2011 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 2011		31 December 2010	
	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	**1,065**	**(390)**	515	(194)
– 100 basis points shift in yield curves	**(977)**	**547**	(556)	173

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

Equity risk

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

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

	31 December 2011		31 December 2010	
	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	**629**	**629**	473	474
10% decrease in equity prices	**(1,075)**	**(1,076)**	(471)	(471)

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

Foreign currency risk

Substantial amounts of the assets and liabilities are denominated in two main currencies, United States dollars and Hong Kong 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 loss in market value resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place 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 166. 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. 91.1% (2010: 96.5%) 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 2011							
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

52 Risk Management *(continued)*

31 December 2010	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	13,087	556	–	–	–	–	13,643
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,087	556	–	–	–	–	13,643
Financial investments	123,893	4,596	–	–	–	–	128,489
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	123,893	4,596	–	–	–	–	128,489
Supporting shareholders funds[1]							
Financial assets designated at fair value	898	19	–	–	–	–	917
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	898	19	–	–	–	–	917
Financial investments	7,755	110	–	–	–	–	7,865
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	7,755	110	–	–	–	–	7,865
Total							
Financial assets designated at fair value	13,985	575	–	–	–	–	14,560
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,985	575	–	–	–	–	14,560
Financial investments	131,648	4,706	–	–	–	–	136,354
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	131,648	4,706	–	–	–	–	136,354

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 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**
31 December 2010							
Linked insurance contracts	1	5,566	–	–	–	–	5,567
Non-linked insurance contracts	444	66	–	71	–	–	581
Total	445	5,632	–	71	–	–	6,148
Reinsurance debtors	35	8	–	46	–	–	89

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 2011, the exposure to the third party was HK$6,663m (2010: HK$5,566m).

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

52 Risk Management *(continued)*

The following table shows the expected maturity of insurance contract liabilities at 31 December 2011:

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 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**
At 31 December 2010					
Non-life insurance	1,736	875	256	54	2,921
Life insurance (non-linked)	11,752	76,103	128,920	141,714	358,489
Life insurance (linked)	1,562	10,338	25,126	66,725	103,751
	15,050	87,316	154,302	208,493	465,161

Remaining contractual maturity of investment contract liabilities

At 31 December 2011	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	**216**	**21**	**60**	**297**
– due between 1 and 5 years	**–**	**–**	**26**	**26**
– due between 5 and 10 years	**259**	**–**	**–**	**259**
– due after 10 years	**–**	**–**	**–**	**–**
– undated[1]	**6,157**	**27,828**	**–**	**33,985**
	6,632	**27,849**	**86**	**34,567**
At 31 December 2010				
Remaining contractual maturity				
– due within 1 year	41	58	84	183
– due between 1 and 5 years	–	–	86	86
– due between 5 and 10 years	316	–	–	316
– due after 10 years	–	–	–	–
– undated[1]	7,121	26,210	–	33,331
	7,478	26,268	170	33,916

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.*

Notes on the Financial Statements (continued)

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 2011 was HK$20,232m (2010: HK$14,767m), 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 during the year 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 now set on an active basis with reference to market risk free yields and have been reduced as a result of removing the implicit adjustments, as shown in the key assumptions table in Note 25b. It should be noted that these refinements will introduce greater volatility within the insurance results in the future which is reflected in higher sensitivity impacts, including sensitivities to lapse, mortality and/or morbidity. A one-off gain of HK$1,133m resulted from these refinements, which is included in "Other operating income" in the consolidated income statement.

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 2011 of reasonably possible changes in the main economic assumption:

	Impact on results	
	2011	2010
	HK$m	HK$m
+ 100 basis points shift in risk-free rate	**1,101**	1,613
– 100 basis points shift in risk-free rate	**(687)**	(1,218)

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

Non-economic assumptions

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. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2011 across all insurance underwriting subsidiaries is as follows:

	Impact on 2011 results		Impact on 2010 results	
	Profit after tax	**Net assets**	Profit after tax	Net assets
	HK$m	**HK$m**	HK$m	HK$m
20% increase in claims costs	**(194)**	**(194)**	(183)	(183)
20% decrease in claims costs	**194**	**194**	183	183
10% increase in mortality and/or morbidity rates	**(406)**	**(406)**	(176)	(176)
10% decrease in mortality and/or morbidity rates	**407**	**407**	167	167
50% increase in lapse rates	**(605)**	**(605)**	351	351
50% decrease in lapse rates	**1,524**	**1,524**	(58)	(58)
10% increase in expense rates	**(286)**	**(286)**	(171)	(171)
10% decrease in expense rates	**285**	**285**	171	171

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. The group raises non-equity core capital and subordinated debt in accordance with HSBC Group's guidelines on market and investor concentration, cost, market conditions, timing, effect on composition and maturity profile. 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.

The group uses the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. The group uses the internal ratings-based (securitisation) approach to determine credit risk for its securitisation exposures. For market risk, the group uses an internal models approach to calculate its general market risk, specific risk for the interest rate risk category and market risk relating to equity options. The group uses the standardised (market risk) approach for calculating other market risk positions 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.

53 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.

54 Nature of business

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

55 Events after the balance sheet date

There have been no events after the balance sheet date that would require disclosure in these financial statements.

56 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 27 February 2012.

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 2011 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 2011. The extracts set out in this Exhibit B are not complete and reference should be made to the Annual Report and Accounts 2011 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 158 to 191.

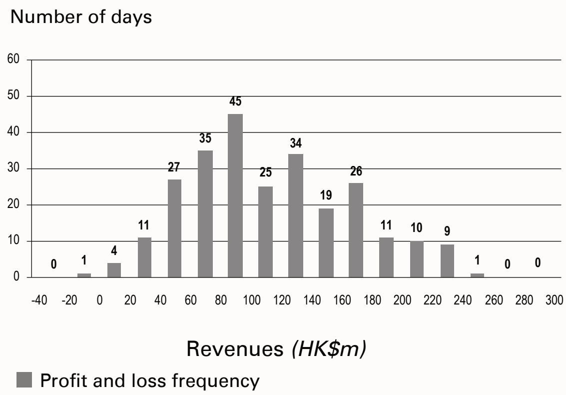
Market Risk Management

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 174 to 178.

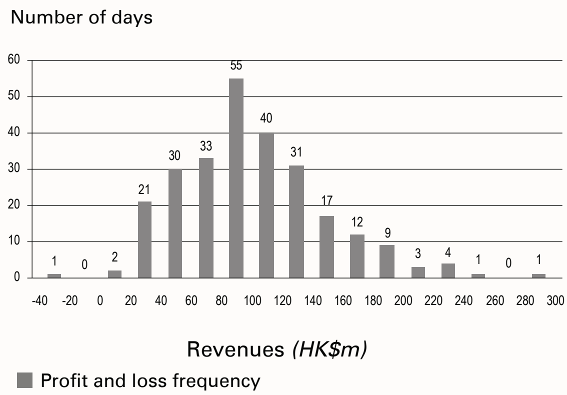
The average daily revenue earned from market risk-related treasury activities in 2011, including accrual book net interest income and funding related to dealing positions, was HK$113m compared with HK$100m in 2010. The standard deviation of these daily revenues was HK$53m (HK$49m for 2010).

An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on 1 day in 2011. The most frequent result was a daily revenue of between HK$80m and HK$100m with 45 occurrences. The highest daily revenue was HK$241m. The most frequent result in 2010 was a daily revenue of between HK$80m and HK$120m with 95 occurrences. The highest daily revenue in 2010 was HK$299m.

Daily distribution of market risk revenues 2011



Daily distribution of market risk revenues 2010



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 and Risk 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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