The Hongkong and Shanghai Banking Corporation Limited

Annual Report and Accounts 2015

HSBC

Annual Report and Accounts 2015

Contents

Certain defined terms

This document comprises the *Annual Report and Accounts* 2015 for The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group'). References to 'HSBC', 'the Group' or 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the People's Republic of China is referred to as 'Hong Kong'. The abbreviations 'HK$m' and 'HK$bn' represent millions and billions (thousands of millions) of Hong Kong dollars respectively.

Cautionary statement regarding forward-looking statements

This *Annual Report and Accounts* contains certain forward-looking statements with respect to the financial condition, results of operations and business of the group.

Statements that are not historical facts, including statements about the Bank's beliefs and expectations, are forward-looking statements. Words such as 'expects', 'anticipates', 'intends', 'plans', 'believes', 'seeks', 'estimates', 'potential' and 'reasonably possible', variations of these words and similar expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made, and it should not be assumed that they have been revised or updated in the light of new information or future events.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement.

Chinese translation

A Chinese translation of the *Annual Report and Accounts* is available upon request from: Communications (Asia), Level 32, HSBC Main Building, 1 Queen's Road Central, Hong Kong. The report is also available, in English and Chinese, on the Bank's website at www.hsbc.com.hk .

本《*年報及賬目*》備有中譯本，如欲查閱可向下址索取：香港皇后大道中 1 號滙豐總行大廈 32 樓企業傳訊部（亞太區）。本年報之中英文本亦載於本行之網址 www.hsbc.com.hk。

Financial Highlights

	2015	2014
	HK$m	HK$m
For the year		
Net operating income before loan impairment charges	**183,514**	173,389
Profit before tax	**117,279**	111,189
Profit attributable to shareholders	**89,533**	86,428
At the year-end		
Total shareholders' equity	**584,201**	557,835
Total equity	**635,886**	608,346
Total capital	**468,863**	425,037
Customer accounts	**4,640,076**	4,479,992
Total assets	**6,953,683**	6,876,746
Ratios	**%**	%
Return on average ordinary shareholders' equity	**15.9**	16.9
Post-tax return on average total assets	**1.40**	1.39
Cost efficiency ratio	**42.0**	42.1
Net interest margin	**1.78**	1.91
Capital ratios		
– Common equity tier 1 capital	**15.6**	14.4
– Tier 1 capital	**16.6**	14.4
– Total capital	**18.6**	15.7

Established in Hong Kong and Shanghai in 1865, The Hongkong and Shanghai Banking Corporation Limited is the founding member of the HSBC Group – one of the world's largest banking and financial services organisations. It is the largest bank incorporated in Hong Kong and one of Hong Kong's three note-issuing banks.

Serving the financial and wealth management needs of an international customer base, the group provides a range of personal, commercial and corporate banking and related financial services in 20 countries and territories in Asia-Pacific, with the largest network of any international financial institution in the region. The group employs some 68,000 people, of whom 37,000 work for the Bank itself.

The Hongkong and Shanghai Banking Corporation Limited is a wholly-owned subsidiary of HSBC Holdings plc, the holding company of the HSBC Group, which has an international network organised into five geographical regions: Europe, Asia, Middle East and North Africa, North America and Latin America.

The Hongkong and Shanghai Banking Corporation Limited
Incorporated in the Hong Kong SAR with limited liability
Registered Office and Head Office: HSBC Main Building, 1 Queen's Road Central, Hong Kong
Telephone: (852) 2822 1111 Facsimile: (852) 2810 1112 Web: www.hsbc.com.hk

Report of the Directors

Principal Activities

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

Asia Strategy

HSBC Group's aim is to be the world's leading international bank. As a subsidiary of the HSBC Group, the group applies a disciplined approach in managing its portfolio of businesses to focus on areas where it has a clear competitive advantage. The Group has set clear strategic actions to capture growth opportunities arising from (i) fast-growing trade corridors and (ii) increasing wealth creation in our priority growth markets. These include delivering growth from our international network, extending our market-leading capability in renminbi products, and specific plans to prioritise and accelerate investments in Association of Southeast Asian Nations countries, the Pearl River Delta, and our Insurance and Asset Management businesses in the region. We will continue to implement global standards as a competitive advantage and to increase the quality of earnings.

The group's strong presence across the Asia-Pacific region will help maintain its competitive advantage in connecting business opportunities within the region, as well as between Asia-Pacific and other parts of the world.

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 79 to 195.

Share Capital

Details of the movements in share capital of the Bank during the financial year, if any, are set out in notes 34 and 35 on the Financial Statements

Dividends

The interim dividends paid in respect of 2015 are set out in note 8 on the Financial Statements. The Directors do not recommend the payment of a final dividend.

Directors

The names of the Directors at the date of this report are set out below:

Stuart T Gulliver, *Chairman*
Peter Tung Shun Wong, *Deputy Chairman & Chief Executive*
Laura May Lung Cha*, GBS, *Deputy Chairman*
Zia Mody*, *Deputy Chairman*
Graham John Bradley*
Dr Christopher Wai Chee Cheng*, GBS, OBE
Dr Raymond Kuo Fung Ch'ien*, GBS, CBE
Irene Yun-lien Lee*
Rose Wai Mun Lee
Jennifer Xinzhe Li*
Victor Tzar Kuoi Li#
James Riley*
John Robert Slosar*
Dr Rosanna Yick-ming Wong*, DBE
Marjorie Mun Tak Yang*, GBS
Tan Sri Dr Francis Sock Ping Yeoh*, CBE

* *independent non-executive Director*
\# *non-executive Director*

All the Directors served throughout the year. Kevin Anthony Westley and Naina L Kidwai retired on 12 May 2015 and 31 October 2015 respectively.

A list of the directors of the Bank's subsidiary undertakings (as defined in the Companies Ordinance Cap. 622) during the period from 1 January 2015 to the date of this report is available on the Bank's website https://www.personal.hsbc.com.hk/1/2/hk/regulatory-disclosures .

Report of the Directors (continued)

Permitted Indemnity Provision

The Bank's Articles of Association provides that the Directors and other officers for the time being of the Bank shall be indemnified out of the Bank's assets against any liability incurred by them or any of them as the holder of any such office or appointment to a person other than the Bank or an associated company of the Bank in connection with any negligence, default, breach of duty or breach of trust in relation to the Bank or associated company (as the case may be).

In addition, the Bank's ultimate holding company, HSBC Holdings plc, has maintained directors' and officers' liability insurance providing appropriate cover for the directors and officers within the Group, including the Directors of the Bank and its subsidiaries.

Directors' Interests in Transactions, Arrangements or Contracts

Save as disclosed below, no transactions, arrangements or contracts that were significant in relation to the Bank's business were entered into or subsisted in the year by the Bank's holding companies, its subsidiaries or any fellow subsidiaries and in which a Director or his or her connected entities had, directly or indirectly, a material interest.

On 25 March 2015, the Bank's fellow subsidiary, HSBC Bank plc ('HBEU') acted as mandated lead arranger, original bank and facility agent in providing Hutchison 3G UK Investments Limited ('H3G UK') with a 24 month GBP6bn bridge loan. HBEU subsequently reduced its commitment by syndicating the facility to 14 other banks in July 2015. H3G UK was, at the time of the transaction, an indirect wholly-owned subsidiary of Hutchison Whampoa Limited, which currently is wholly-owned by CK Hutchison Holdings Limited, an associated body corporate of Mr Victor Li, a non-executive Director of the Bank.

Directors' Rights to Acquire Shares or Debentures

To help align the interests of employees with shareholders, executive Directors are eligible to be granted conditional awards over ordinary shares in HSBC Holdings plc by that company (being the ultimate holding company) under the HSBC Share Plan 2011, the Group Performance Share Plan ('GPSP') and the HSBC International Employee Share Purchase Plan.

The GPSP was developed to incentivise senior executives to deliver sustainable long-term business performance which aligns interests between senior executives of HSBC Group and shareholders. For executive Directors and Group Managing Directors of HSBC Holdings plc, there is further alignment as they are required to hold the shares once the awards have vested, until retirement. The GPSP is a long-term incentive plan under the HSBC Share Plan 2011. The award levels of GPSP are determined by considering performance up to the date of grant against enduring performance measures set out in the long-term performance scorecard. The GPSP award is subject to a five year vesting period. The vesting of conditional deferred awards over shares in HSBC Holdings plc granted to executive Directors under the HSBC Share Plan 2011 are generally subject to the individual remaining an employee on the vesting date. Group General Managers receive long term incentive awards that are subject to a five year vesting period.

Executive Directors, Group Managing Directors and Group General Managers are also eligible to receive an annual incentive award based on the outcome of the performance measures set out in the annual scorecard. 50% of the annual incentive awards consists of shares granted under the HSBC Share Plan 2011. 60% of the shares granted as part of the annual incentive awards is in the form of conditional deferred share awards which vests over a period of three years. All net shares (net of estimated tax and social security obligations) that are vested as part of the annual incentive awards are subject to a six month retention period post vesting.

All unvested deferred awards made under the HSBC Share Plan 2011, including GPSP, are subject to application of malus, i.e. the cancellation and reduction of unvested deferred awards. Effective from 1 January 2015, all paid or vested variable pay awards made to Identified Staff and Material Risk Takers ('MRTs') will be subject to clawback for a period of 7 years from the date of grant.

Immediately vested conditional share awards which are subject to retention only are also granted under the HSBC Share Plan 2011. These include the Fixed Pay Allowance ('FPA') share awards which are non-forfeitable, immediately vested but subject to retention, which were introduced as part of a new remuneration policy approved by HSBC Holdings plc shareholders at its Annual General Meeting ('AGM') in May 2014. Under the retention terms attached to the FPA shares granted for 2015, 20% of the net shares (net of estimated tax and social security obligations) is to be retained until March 2016, while 80% of the net shares is to be retained until March 2021.

The HSBC International Employee Share Purchase Plan is an employee share purchase plan offered to employees in Hong Kong since 2013 and has been extended to further countries in the HSBC Group from 2014. For every three shares in HSBC Holdings plc purchased by an employee ('Investment Shares'), a conditional award to acquire one share is granted ('Matching Shares'). The employee becomes entitled to the Matching Shares subject to continued employment with HSBC and retention of the Investment Shares until the third anniversary of the start of the relevant plan year.

Share options have previously been granted to executive Directors under the HSBC Holdings Group Share Option Plan ('GSOP'). No options have been granted under the GSOP since 26 May 2005 and the exercise period of the last option ended in 2015.

During the year, Stuart Gulliver, Naina Kidwai, Rose Lee and Peter Wong acquired or were awarded shares of HSBC Holdings plc under the terms of the HSBC Share Plan 2011, which includes GPSP and FPA share awards.

Apart from these arrangements, at no time during the year was the Bank, its holding companies, its subsidiaries or any fellow subsidiaries a party to any arrangements to enable the Directors to acquire benefits by means of the acquisition of shares in or debentures of the Bank or any other body corporate.

Donations

Donations made by the Bank and its subsidiaries during the year amounted to HK$783m (2014: HK$212m).

Compliance with the Banking (Disclosure) Rules

The Directors are of the view that the *Annual Report and Accounts* 2015, and Supplementary Notes on the Financial Statements 2015, which will be published separately, fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance.

Auditor

The *Annual Report and Accounts* have been audited by PricewaterhouseCoopers ('PwC'). A resolution to reappoint PwC as auditor of the Bank will be proposed at the forthcoming AGM.

Corporate Governance

The Bank is committed to high standards of corporate governance. As an Authorised Institution, the Bank is subject to and complies with the Hong Kong Monetary Authority ('HKMA') Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions'. During 2015, the 'comply or explain' Corporate Governance Code for HSBC Group companies, which was introduced by the Group in 2013, has been implemented by the Bank and its subsidiaries.

Board of Directors

The Board, led by the Chairman, provides entrepreneurial leadership of the Bank within a framework of prudent and effective controls which enables risks to be assessed and managed. The Directors are collectively responsible for the long-term success of the Bank and delivery of sustainable value to shareholders. The Board sets the strategy and risk appetite for the group and approves capital and operating plans presented by management for the achievement of the strategic objectives it has set.

Report of the Directors (continued)

Directors

The Bank has a unitary Board. The authority of each Director is exercised in Board meetings where the Board acts collectively. As at 22 February 2016, the Board comprised the Chairman, Deputy Chairman and Chief Executive, two Deputy Chairmen who are independent non-executive Directors, one other Director with executive responsibilities for a subsidiary's operations, one non-executive Director and another ten independent non-executive Directors.

Independence of non-executive Directors

Non-executive Directors are not HSBC employees and do not participate in the daily business management of the Bank. They bring an external perspective, constructively challenge and help develop proposals on strategy, scrutinize the performance of management in meeting agreed goals and objectives, and monitor the risk profile and reporting of performance of the Bank. The non-executive Directors bring experience from a number of industries and business sectors, including the leadership of large complex multinational enterprises. The Board has determined that each non-executive Director is independent in character and judgement and that twelve Directors are independent for the purpose of notification to the HKMA and under the Corporate Governance Code for HSBC Group Companies. In making this determination, it was agreed that there are no relationships or circumstances likely to affect the judgement of the independent non-executive Directors, with any relationships or circumstances that could appear to do so not considered to be material.

Chairman and Chief Executive

The roles of Chairman and Chief Executive are separate and held by experienced full-time employees of the HSBC Group. There is a clear division of responsibilities between leading the Board and the executive responsibility for running the Bank's business.

The Chairman provides leadership to the Board and is responsible for the overall effective functioning of the Board. The Chairman is responsible for the development of strategy and the oversight of implementation of Board approved strategies and direction. The Chief Executive is responsible for ensuring implementation of the strategy and policy as established by the Board and the day-to-day running of operations. The Chief Executive is chairman of the Executive Committee and the Asset and Liability Management Committee. Each Asia-Pacific Global Business and Global Function head reports to the Chief Executive.

Board Committees

The Board has established various committees consisting of Directors and senior management. The Board and each Board committee have terms of reference to document their responsibilities and governance procedures. The key roles of the committees are described in the paragraphs below. The chairman of each Board committee reports to each subsequent Board meeting when presenting the meeting minutes of the relevant committee.

Executive Committee

The Executive Committee meets monthly and is responsible for the exercise of all of the powers, authorities and discretions of the Board in so far as they concern the management, operations and day-to-day running of the group, in accordance with such policies and directions as the Board may from time to time determine, with power to sub-delegate. A schedule of items that require the approval of the Board is maintained.

The Bank's Deputy Chairman and Chief Executive, Peter Wong, is Chairman of the Committee. The current members of the Committee are: Diana Cesar *(Chief Executive Officer Hong Kong)*, Pui Mun Chan *(Head of Regulatory Compliance Asia-Pacific)*, Raymond Cheng *(Chief Operating Officer Asia-Pacific)*, Gordon French *(Head of Global Banking and Markets Asia-Pacific)*, Kathleen Gan *(Chief Financial Officer)*, Guy Harvey-Samuel *(Chief Executive Officer Singapore)*, Mukhtar Hussain *(Chief Executive Officer Malaysia)*, Vincent Li *(Head of Financial Crime Compliance, Asia-Pacific)*, David Liao *(Chief Executive Officer China)*, Kevin Martin *(Regional Head of Retail Banking and Wealth Management Asia-Pacific)*, Mark McKeown *(Chief Risk Officer, Asia-Pacific)*, Stuart Milne *(Chief Executive Officer India)*, Kenneth Ng *(Regional General Counsel Asia-Pacific)*, Bernard Rennell *(Regional Head of Global Private Banking Asia-Pacific)*, Jayant Rikhye *(Head of Strategy and Planning, Asia-Pacific and Head of International Asia-Pacific)*, Paul Skelton *(Regional Head of Commercial Banking, Asia-Pacific)*, Donna Wong *(Head of Human Resources Asia-Pacific)*, Helen Wong *(Chief Executive Officer Greater China)*. Paul Stafford *(Corporation Secretary)* is the Committee Secretary. In attendance are: Malcolm Wallis *(Head of Communications Asia-Pacific)* and William Tam *(Deputy Secretary)*.

Asset and Liability Management Committee

The Asset and Liability Management Committee is chaired by the Deputy Chairman and Chief Executive and is responsible for providing direction on and monitoring of the group's balance sheet composition and capital (including Economic Capital), liquidity and funding structure, and structural exposures under normal and stressed conditions. The Committee consists of senior executives of the Bank, most of whom are members of the Executive Committee.

Risk Management Committee

The Risk Management Committee is chaired by the Chief Risk Officer and is responsible for the executive oversight of the risk framework for the group. The Committee consists of senior executives of the Bank, most of whom are members of the Executive Committee.

Audit Committee

The Audit Committee meets at least four times a year and has non-executive responsibility for oversight of and advise to the Board on matters relating to financial reporting.

The current members of the Committee, all being independent non-executive Directors, are James Riley (Chairman of the Committee), Graham Bradley, Irene Lee and Jennifer Li.

Governance structure

The Audit Committee monitors the integrity of the Financial Statements and oversees the internal control systems over financial reporting, covering all material controls. The Committee reviews the adequacy of resources, qualifications and experience of staff of the accounting and financial reporting function and their training programmes and budget. The Committee also reviews the Financial Statements before submission to the Board. It also monitors and reviews the effectiveness of the internal audit function and reviews the Bank's financial and accounting policies and practices. The Committee advises the Board on the appointment of the external auditor and is responsible for oversight of the external auditor. As part of the monitoring process, the Committee reviews minutes of meetings of subsidiaries' Audit Committees and the Asset and Liability Management Committee.

Risk Committee

The Risk Committee meets at least four times a year and has non-executive responsibility for oversight of and advice to the Board on high-level risk-related matters and risk governance. The current members of the Committee, all being independent non-executive Directors, are Graham Bradley (Chairman of the Committee), Dr Christopher Cheng, Zia Mody and James Riley.

Report of the Directors (continued)

Risk governance and culture

All of the Bank's activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combination of risks. The Board, advised by the Risk Committee, requires and encourages a strong risk governance culture which shapes the Bank's attitude to risk.

The Bank's risk governance is supported by a clear policy of risk ownership and accountability of all staff for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by clear and consistent employee communication on risk that sets the tone from senior leadership, the governance structure, mandatory learning and remuneration policy, helps to foster a disciplined and constructive culture of risk management and control throughout the group.

Risk management

The Board and the Risk Committee oversee the maintenance and development of a strong risk management framework by continually monitoring the risk environment, top and emerging risks facing the group and mitigating actions planned and taken. The Risk Committee recommends the approval of group's risk appetite statement to the Board and monitors performance against the key performance/risk indicators included within the statement. The Risk Committee monitors the risk profiles for all of the risk categories within the group's business. The Committee also monitors the effectiveness of the Bank's risk management and internal controls, including operational and compliance controls, and risk management systems.

Reports on these items are presented at each meeting of the Committee. Regular reports from the Risk Management Committee, which is the executive body responsible for overseeing risk, are also presented.

Risk appetite

Risk appetite is set out in the group's Risk Appetite Statement ('RAS'), which describes the types and quantum of risks (both tangible and intangible) that the group is prepared to accept in order to achieve its medium and long-term strategic goals. It is approved by the Board on the advice of the Risk Committee, and is a key component of our risk management framework. The Risk Management Committee, through their risk management oversight role, coordinates the process of aligning risk appetite and risk strategy with business strategy, oversees monitoring, reporting and governance around the risk appetite process, agrees remedial action should the risk profile fall outside agreed parameters and communicates risk appetite. Across the group, each country and regional Global Business is required to prepare a RAS. The regional Risk function tracks the RAS development and performance across sites on a regular basis.

Quantitative and qualitative metrics are assigned to primary categories including: earnings, capital, liquidity and funding, intra-group lending, risk categories and risk diversification and concentration. Measurement against these metrics serves to:

- guide underlying business activity, ensuring it is aligned to RASs;
- determine risk-adjusted remuneration;
- enable the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and
- promptly identify business decisions needed to mitigate risks.

Top and emerging risks

The Board and the Risk Committee oversee the maintenance and development of a strong risk management framework by the continual monitoring of the risk environment and top and emerging risks facing the Bank, and mitigating actions planned and taken.

The Bank's businesses are exposed to a variety of risk factors that could potentially affect the results of operations or financial condition. Identifying and monitoring top and emerging risks are integral to our approach to risk management. A 'top risk' is defined as a current, emerged risk which has arisen across any risk category, region or global business and has the potential to have a material impact on the Bank's financial results or reputation and the sustainability of the long-term business model, and which may form and crystallise within a six months to one year's horizon. An 'emerging risk' is considered to be one with potentially significant but uncertain outcomes which may form and crystallise beyond a year, in the event of which it could have a material effect on our ability to achieve our long-term strategy. Our top and emerging risk framework enables us to focus on current and forward looking aspects of our risk exposures and ensure our risk profile remains in line with our risk appetite and that our appetite remains appropriate. Top and emerging risks fall under the following three broad categories:

- macro-economic and geopolitical risk;
- macro-prudential, regulatory and legal risks to the Bank's business model; and
- risks related to business operations, governance and internal control systems.

Stress testing

The stress testing and scenario analysis programme is central to the monitoring of top and emerging risks. The Bank conducts a range of Group stress-testing scenarios including, but not limited to, severe global economic downturn, country, sector and counterparty failures and a variety of projected major operational risk events. As a major HSBC subsidiary, the Bank also conducts regular macroeconomic and event-driven scenario analyses specific to Asia-Pacific. The outcomes of the stress tests are used to assess the potential impacts on the Bank. The Bank also participates, where appropriate, in stress tests requested by regulatory bodies.

Stress testing is used across risk categories such as credit risk, market risk, liquidity and funding risk and operational risk to evaluate the potential impact of stress scenarios on portfolio values, structural long-term funding positions, income or capital.

The Bank also conducts reverse stress testing. Reverse stress testing is a process of working backwards from the non-viability of the business to identify scenarios that could bring the Bank to that point. Non-viability might occur before the Bank's capital is depleted, and could result from a variety of events. These include idiosyncratic, systemic or combinations of events, and/or could imply failure of the Bank or one of its major subsidiaries and does not necessarily mean the simultaneous failure of all the major subsidiaries.

The Bank uses reverse stress testing as part of our risk management process to strengthen resilience.

Nomination Committee

The Nomination Committee meets at least twice a year and is responsible for leading the process for Board appointments and for identifying and nominating, for the approval of the Board, candidates for appointment to the Board. Appointments to the Board are subject to the approval of the HKMA. The Committee considers plans for orderly succession to the Board and the appropriate balance of skills and experience on the Board.

The current members of the Committee, being a majority of independent non-executive Directors, are Stuart Gulliver (Chairman of the Committee), Laura Cha and Marjorie Yang. Peter Wong attends each meeting of the Committee.

Chairman's Committee

The Chairman's Committee acts on behalf of the Board either in accordance with authority delegated by the Board from time to time, or as specifically set out within its terms of reference. The Committee meets with such frequency and at such times as it may determine, and can implement previously agreed strategic decisions, approve specified matters subject to their prior review by the full Board, and act exceptionally on urgent matters within its terms of reference.

The current members of the Committee comprise the Chairman of the Board, the Deputy Chairman and Chief Executive, the non-executive Deputy Chairmen and the Chairmen of the Audit and Risk Committees.

Report of the Directors (continued)

Group Remuneration Committee

The Board of the Bank's ultimate holding company, HSBC Holdings plc, has established a Group Remuneration Committee comprising independent non-executive Directors. The Committee is responsible for determining and approving the Group's remuneration policy. The Committee also determines the remuneration of Directors, other senior Group employees, employees in positions of significant influence and employees whose activities have or could have an impact on the Bank's risk profile, and in doing so takes into account the pay and conditions across the HSBC Group. Having a Group Remuneration Committee is consistent with the principles set out in the HKMA Supervisory Policy Manual CG-5 'Guideline on a Sound Remuneration System'.

Remuneration policy

The remuneration policy for the HSBC Group, approved by the Group Remuneration Committee and applicable to the Bank, aims to reward success, not failure, and to be properly aligned with the risk management framework and risk outcomes. In order to ensure alignment between remuneration and business strategy, individual remuneration is determined through assessment of performance, delivered against both annual and long-term objectives summarised in performance scorecards, as well as adherence to HSBC Values of being 'open, connected and dependable' and acting with 'courageous integrity'. Altogether, performance is judged not only on what is achieved over the short and long term, but also on how it is achieved, as the latter contributes to the sustainability of the organisation. The financial and non-financial measures incorporated in the annual and long-term scorecards are carefully considered to ensure alignment with the long-term strategy of the HSBC Group.

An annual review of the Bank's remuneration strategy and its operation is commissioned externally and carried out independently of management. The review confirms that the Bank's remuneration policy is consistent with the principles set out in the HKMA Supervisory Policy Manual CG-5 'Guideline on a Sound Remuneration System'.

In accordance with the 'Guideline on a Sound Remuneration System', details of the remuneration strategy are contained within the *Annual Report and Accounts* 2015 of HSBC Holdings plc.

Banking structural reform and recovery and resolution planning

Globally there have been a number of developments relating to banking structural reform and the introduction of recovery and resolution regimes.

The HSBC Group is working with our primary regulators to develop and agree a resolution strategy for the HSBC Group. It is our view that a strategy by which the Group breaks up at a subsidiary bank level at the point of resolution (referred to as a Multiple Point of Entry strategy) is the optimal approach as it is aligned to our existing legal and business structure.

Similar to all Global Systemically Important Banks ('G-SIBs'), the Group is working with our regulators to mitigate or remove critical inter-dependencies between our subsidiaries to further facilitate the resolution of the HSBC Group. In particular, in order to remove operational dependencies (where one subsidiary bank provides critical services to another), the HSBC Group is in the process of transferring critical services from our subsidiary banks to a separate internal group of service companies ('ServCo Group'). Transfers of employees, critical shared services and assets in Hong Kong will be considered in due course.

Business review

The Bank is exempt from the requirement to prepare a business review under section 388(3) of the Companies Ordinance Cap. 622 since it is a wholly-owned subsidiary of HSBC Holdings plc.

On behalf of the Board
Stuart Gulliver, *Chairman*
22 February 2016

Financial Review

Summary of Financial Performance *(Unaudited)*

Results for 2015

Profit before tax for 2015 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') increased by HK$6,090m, or 5%, to HK$117,279m.

Profit before tax

	2015 **HK$m**	2014 HK$m
Hong Kong	**72,872**	62,966
Rest of Asia-Pacific	**44,407**	48,223
Total	**117,279**	111,189

Geographical Regions

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 business. 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 influential in determining performance across the different types of business activity carried out in the region. Therefore, the provision of segmental 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 Hong Kong Financial Reporting Standards ('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 ('RBWM') serves personal customers. We take deposits and provide transactional banking services to enable customers to manage their day to day finances and save for the future. We selectively offer credit facilities to assist customers in their short or longer-term borrowing requirements; and we provide financial advisory, broking, insurance and investment services to help them manage and protect their financial futures.
- Commercial Banking ('CMB') is segmented into Corporate, to serve both corporate and mid-market companies with more sophisticated financial needs, and Business Banking, to serve small and medium-sized enterprises ('SMEs'), enabling differentiated coverage of our target customers. This allows us to provide continuous support to companies as they grow both domestically and internationally, and ensures a clear focus on internationally aspirant customers.
- Global Banking and Markets ('GB&M') provides tailored financial solutions to major government, corporate and institutional clients worldwide. GB&M operates a long-term relationship management approach to build a full understanding of clients' financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs.
- Global Private Banking ('GPB') provides investment management and trustee solutions to high net worth individuals and their families. We aim to meet the needs of our clients by providing excellent customer service, leveraging our global footprint and offering a comprehensive suite of solutions.

Financial Review (continued)

Geographical Regions *(continued)*

Profit before tax by geographical region

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2015				
Net interest income	**52,660**	**41,717**	**–**	**94,377**
Net fee income	**32,320**	**13,339**	**–**	**45,659**
Net trading income	**13,681**	**9,935**	**–**	**23,616**
Net income /(expense) from financial instruments designated at fair value	**(3,220)**	**660**	**–**	**(2,560)**
Gains less losses from financial investments	**11,290**	**321**	**–**	**11,611**
Dividend income	**192**	**18**	**–**	**210**
Net insurance premium income	**45,758**	**6,835**	**–**	**52,593**
Other operating income	**12,992**	**1,433**	**(3,986)**	**10,439**
Total operating income	**165,673**	**74,258**	**(3,986)**	**235,945**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(45,909)**	**(6,522)**	**–**	**(52,431)**
Net operating income before loan impairment charges and other credit risk provisions	**119,764**	**67,736**	**(3,986)**	**183,514**
Loan impairment charges and other credit risk provisions	**(1,199)**	**(3,875)**	**–**	**(5,074)**
Net operating income	**118,565**	**63,861**	**(3,986)**	**178,440**
Operating expenses	**(45,933)**	**(35,044)**	**3,986**	**(76,991)**
Operating profit	**72,632**	**28,817**	**–**	**101,449**
Share of profit in associates and joint ventures	**240**	**15,590**	**–**	**15,830**
Profit before tax	**72,872**	**44,407**	**–**	**117,279**
2014				
Net interest income	50,774	44,333	2	95,109
Net fee income	29,996	14,626	–	44,622
Net trading income	11,663	8,559	(2)	20,220
Net income from financial instruments designated at fair value	3,134	914	–	4,048
Gains less losses from financial investments	2,286	103	–	2,389
Dividend income	1,362	12	–	1,374
Net insurance premium income	50,226	7,081	–	57,307
Other operating income	10,872	1,693	(4,063)	8,502
Total operating income	160,313	77,321	(4,063)	233,571
Net insurance claims and benefits paid and movement in liabilities to policyholders	(52,916)	(7,266)	–	(60,182)
Net operating income before loan impairment charges and other credit risk provisions	107,397	70,055	(4,063)	173,389
Loan impairment charges and other credit risk provisions	(2,478)	(2,447)	–	(4,925)
Net operating income	104,919	67,608	(4,063)	168,464
Operating expenses	(42,270)	(34,743)	4,063	(72,950)
Operating profit	62,649	32,865	–	95,514
Share of profit in associates and joint ventures	317	15,358	–	15,675
Profit before tax	62,966	48,223	–	111,189

Geographical Regions *(continued)*

Hong Kong profit before tax 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$m	Intra-segment elimination HK$m	Hong Kong Total HK$m
2015							
Net interest income/(expense)	**27,589**	**16,627**	**10,325**	**817**	**(1,822)**	**(876)**	**52,660**
Net fee income	**18,215**	**7,551**	**5,217**	**1,134**	**203**	**–**	**32,320**
Net trading income/(expense)	**1,036**	**1,263**	**10,387**	**738**	**(619)**	**876**	**13,681**
Net income/(expense) from financial instruments designated at fair value	**(3,180)**	**(243)**	**51**	**–**	**152**	**–**	**(3,220)**
Gains less losses from financial investments	**276**	**182**	**197**	**–**	**10,635**	**–**	**11,290**
Dividend income	**1**	**–**	**4**	**–**	**187**	**–**	**192**
Net insurance premium income	**41,057**	**4,721**	**–**	**–**	**(20)**	**–**	**45,758**
Other operating income	**4,675**	**905**	**718**	**9**	**8,532**	**(1,847)**	**12,992**
Total operating income	**89,669**	**31,006**	**26,899**	**2,698**	**17,248**	**(1,847)**	**165,673**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(40,683)**	**(5,226)**	**–**	**–**	**–**	**–**	**(45,909)**
Net operating income before loan impairment charges and other credit risk provisions	**48,986**	**25,780**	**26,899**	**2,698**	**17,248**	**(1,847)**	**119,764**
Loan impairment (charges)/releases and other credit risk provisions	**(1,311)**	**(206)**	**322**	**(4)**	**–**	**–**	**(1,199)**
Net operating income	**47,675**	**25,574**	**27,221**	**2,694**	**17,248**	**(1,847)**	**118,565**
Operating expenses	**(18,448)**	**(7,094)**	**(11,381)**	**(1,559)**	**(9,298)**	**1,847**	**(45,933)**
Operating profit	**29,227**	**18,480**	**15,840**	**1,135**	**7,950**	**–**	**72,632**
Share of profit in associates and joint ventures	**236**	**1**	**3**	**–**	**–**	**–**	**240**
Profit before tax	**29,463**	**18,481**	**15,843**	**1,135**	**7,950**	**–**	**72,872**
2014							
Net interest income/(expense)	25,464	15,367	11,896	782	(2,287)	(448)	50,774
Net fee income	16,443	7,568	4,816	1,017	152	–	29,996
Net trading income/(expense)	937	1,429	8,086	810	(47)	448	11,663
Net income/(expense) from financial instruments designated at fair value	3,290	(65)	(19)	–	(72)	–	3,134
Gains less losses from financial investments	3	33	1,111	–	1,139	–	2,286
Dividend income	1	–	6	–	1,355	–	1,362
Net insurance premium income	46,159	4,067	–	–	–	–	50,226
Other operating income	3,277	331	572	10	8,616	(1,934)	10,872
Total operating income	95,574	28,730	26,468	2,619	8,856	(1,934)	160,313
Net insurance claims and benefits paid and movement in liabilities to policyholders	(48,870)	(4,046)	–	–	–	–	(52,916)
Net operating income before loan impairment charges and other credit risk provisions	46,704	24,684	26,468	2,619	8,856	(1,934)	107,397
Loan impairment (charges)/releases and other credit risk provisions	(1,149)	(684)	(652)	7	–	–	(2,478)
Net operating income	45,555	24,000	25,816	2,626	8,856	(1,934)	104,919
Operating expenses	(16,969)	(6,445)	(11,016)	(1,361)	(8,413)	1,934	(42,270)
Operating profit	28,586	17,555	14,800	1,265	443	–	62,649
Share of profit in associates and joint ventures	311	2	4	–	–	–	317
Profit before tax	28,897	17,557	14,804	1,265	443	–	62,966

Financial Review (continued)

Geographical Regions *(continued)*

Hong Kong reported pre-tax profits of HK$72,872m compared with HK$62,966m in 2014, an increase of 16%, mainly reflecting the gain on the partial disposal of Hang Seng's shareholding in Industrial Bank Co., Limited ('Industrial Bank') of HK$10,636m in 2015.

Revenue increased by HK$12,367m, or 12%, mainly reflecting the gain on the partial disposal of Industrial Bank mentioned above, coupled with revenue growth across all global businesses. Revenue in 2015 also included a gain from the 150th anniversary banknotes issuance, which was fully offset by a corresponding increase in operating expenses related to this issuance. These increases were partly offset by lower dividend income from Industrial Bank following the partial disposal, and the non-recurrence of various one-offs in 2014, namely the gains from disposal of our shareholding in Bank of Shanghai of HK$3,320m and our interest in private equity funds of HK$961m, and an impairment charge against our investment in Industrial Bank of HK$2,103m.

Revenue in RBWM increased by 5% compared with 2014, driven by higher net interest income from growth in average lending and deposit balances. Net fee income also increased from higher securities brokerage driven by higher stock market turnover in the first half of 2015. These increases were partly offset by lower insurance income, mainly reflecting the unfavourable equity market performance in the second half of the year.

Revenue in CMB increased by 4%, mainly due to higher net interest income from average balance sheet growth, coupled with wider spreads on customer deposits and trade-related lending.

Revenue in GB&M increased by 2%, mainly from higher trading income in Equities and from increased client flows in Foreign Exchange ('FX'), coupled with higher Capital Financing income. These increases were partly offset by lower revenue in Balance Sheet Management ('BSM').

Loan impairment charges were lower by HK$1,279m compared with 2014, mainly in GB&M due to an individually assessed impairment charge in 2014, followed by a partial release in 2015.

Operating expenses rose by HK$3,663m or 9% compared with 2014, mainly due to higher staff costs from wage inflation and increased average headcount to support business growth, coupled with higher investment in regulatory programmes and compliance. The increase also included charitable donations and other expenses in relation to the 150th anniversary banknotes issuance.

Geographical Regions *(continued)*

Rest of Asia-Pacific profit before tax 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$m	Intra-segment elimination HK$m	Rest of Asia-Pacific Total HK$m
2015							
Net interest income	**12,196**	**11,383**	**15,878**	**539**	**1,151**	**570**	**41,717**
Net fee income/(expense)	**4,349**	**3,816**	**4,748**	**524**	**(98)**	**–**	**13,339**
Net trading income	**528**	**1,379**	**7,919**	**253**	**426**	**(570)**	**9,935**
Net income/(expense) from financial instruments designated at fair value	**629**	**11**	**25**	**–**	**(5)**	**–**	**660**
Gains less losses from financial investments	**(6)**	**(3)**	**236**	**–**	**94**	**–**	**321**
Dividend income	**11**	**–**	**–**	**–**	**7**	**–**	**18**
Net insurance premium income	**5,511**	**1,328**	**–**	**–**	**–**	**(4)**	**6,835**
Other operating income	**428**	**249**	**471**	**23**	**965**	**(703)**	**1,433**
Total operating income	**23,646**	**18,163**	**29,277**	**1,339**	**2,540**	**(707)**	**74,258**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(5,260)**	**(1,261)**	**–**	**–**	**–**	**(1)**	**(6,522)**
Net operating income before loan impairment charges and other credit risk provisions	**18,386**	**16,902**	**29,277**	**1,339**	**2,540**	**(708)**	**67,736**
Loan impairment (charges)/releases and other credit risk provisions	**(1,060)**	**(2,881)**	**72**	**(1)**	**(5)**	**–**	**(3,875)**
Net operating income	**17,326**	**14,021**	**29,349**	**1,338**	**2,535**	**(708)**	**63,861**
Operating expenses	**(14,856)**	**(8,565)**	**(9,780)**	**(885)**	**(1,666)**	**708**	**(35,044)**
Operating profit	**2,470**	**5,456**	**19,569**	**453**	**869**	**–**	**28,817**
Share of profit in associates and joint ventures	**2,029**	**11,223**	**2,338**	**–**	**–**	**–**	**15,590**
Profit before tax	**4,499**	**16,679**	**21,907**	**453**	**869**	**–**	**44,407**
2014							
Net interest income	13,331	11,299	15,909	590	2,053	1,151	44,333
Net fee income/(expense)	4,949	4,286	5,075	417	(101)	–	14,626
Net trading income/(expense)	635	1,466	7,384	288	(63)	(1,151)	8,559
Net income/(expense) from financial instruments designated at fair value	920	15	5	–	(26)	–	914
Gains less losses from financial investments	5	5	79	–	14	–	103
Dividend income	5	1	–	–	6	–	12
Net insurance premium income	4,981	2,115	–	–	1	(16)	7,081
Other operating income	724	404	489	3	775	(702)	1,693
Total operating income	25,550	19,591	28,941	1,298	2,659	(718)	77,321
Net insurance claims and benefits paid and movement in liabilities to policyholders	(5,246)	(2,032)	–	–	–	12	(7,266)
Net operating income before loan impairment charges and other credit risk provisions	20,304	17,559	28,941	1,298	2,659	(706)	70,055
Loan impairment (charges)/releases and other credit risk provisions	(1,319)	(1,080)	(50)	1	1	–	(2,447)
Net operating income	18,985	16,479	28,891	1,299	2,660	(706)	67,608
Operating expenses	(15,326)	(8,271)	(9,629)	(885)	(1,338)	706	(34,743)
Operating profit	3,659	8,208	19,262	414	1,322	–	32,865
Share of profit in associates and joint ventures	2,042	11,019	2,295	–	2	–	15,358
Profit before tax	5,701	19,227	21,557	414	1,324	–	48,223

Financial Review (continued)

Geographical Regions *(continued)*

Rest of Asia-Pacific reported pre-tax profits of HK$44,407m compared with HK$48,223m in 2014, a decrease of 8%. The decrease in pre-tax profits was largely due to an unfavourable impact from foreign exchange. Excluding this impact, pre-tax profits dropped by 3%, mainly due to higher operating expenses and higher loan impairment charges, partly offset by increased revenue.

Excluding the unfavourable impact from foreign exchange, revenue increased by 4% compared with 2014, with growth reported by most countries across the region.

In mainland China, revenue increased by 4%, notably in GB&M from higher Securities Services income due to strong average deposit growth. Income from FX and Rates also increased, partly offset by lower net interest income in Payments and Cash Management from deposit spread compression, and in BSM following successive interest rate cuts.

Elsewhere in Asia, excluding the impact from foreign exchange, revenue increased in Malaysia driven by higher revenue in GB&M. In Singapore, revenue increased mainly from higher net interest income, benefiting from wider deposit spreads. Revenue in India and Indonesia also increased, mainly due to higher net interest income from growth in customer lending and deposits, while Indonesia also benefited from improved lending spreads. These increases were partly offset by lower revenue in Taiwan.

Loan impairment charges increased by HK$1,428m compared with 2014, driven by Indonesia and to a lesser extent India, Australia and Singapore, partly offset by lower impairment charges in mainland China and Vietnam.

Operating expenses increased by HK$301m, or 1% compared with 2014. Excluding the impact from foreign exchange, operating expenses increased by 9%, mainly from higher staff costs due to termination benefits in India, and from wage inflation across the region. Other administrative expenses also increased from higher usage of Global Services Centres, coupled with increased investment in regulatory programmes and compliance.

Share of profits in associates and joint ventures rose by HK$232m, mainly from a higher share of profits from Bank of Communications Co., Limited.

Net interest income

	2015 **HK$m**	2014 HK$m
Net interest income	**94,377**	95,109
Average interest-earning assets	**5,311,284**	4,977,727
Net interest margin	**%**	%
Spread	**1.67**	1.79
Contribution from net free funds	**0.11**	0.12
Total	**1.78**	1.91

Net interest income ('NII') decreased by HK$732m compared with 2014 due to an unfavourable foreign exchange impact. Excluding the impact from foreign exchange, NII rose by HK$2,410m, or 3%, mainly from balance sheet growth, although this was partly offset by a reduction in net interest margin in most countries across the region, coupled with lower BSM revenue in Hong Kong and mainland China.

Average interest-earning assets increased by HK$334bn, or 7%, compared with 2014. Excluding the impact from foreign exchange, average financial investments increased by 16%, while customer lending grew by 6%, notably in term lending and mortgages.

Net interest margin decreased by 13 basis points compared with 2014, driven by compressed spreads on both customer deposits and lending, coupled with lower yields on financial investments.

In Hong Kong, the net interest margin for the Bank decreased by nine basis points, mainly due to compressed spreads on term lending and lower reinvestment yields in BSM, although the decrease was partly offset by improved spreads on trade-related lending and corporate customer deposits.

At Hang Seng Bank, the net interest margin decreased by 13 basis points, mainly due to compressed spreads on customer lending and lower reinvestment yields in BSM, partly offset by improved customer deposit spreads.

In the Rest of Asia-Pacific, the net interest margin also decreased in most countries in the region, notably in mainland China due to lower reinvestment yields in BSM and compressed customer deposit spreads, in Australia from compressed customer deposit spreads, and in Malaysia from narrower customer lending spreads.

Financial Review (continued)

Net fee income

	2015 HK$m	2014 HK$m
Brokerage	**9,327**	7,697
Cards	**7,072**	7,082
Unit trust	**6,598**	6,531
Import/export	**4,340**	4,968
Funds under management	**4,461**	4,193
Remittances	**3,438**	3,508
Credit facilities	**3,219**	2,997
Account services	**2,976**	2,925
Underwriting	**1,214**	1,949
Insurance	**1,482**	1,400
Other	**7,799**	7,412
Fee income	**51,926**	50,662
Fee expense	**(6,267)**	(6,040)
Net fee income	**45,659**	44,622

Net trading income

	2015 HK$m	2014 HK$m
Dealing profits	**17,523**	13,674
Net interest income on trading assets and liabilities	**4,439**	5,168
Dividend income from trading securities	**1,674**	1,384
Net loss from hedging activities	**(20)**	(6)
Net trading income	**23,616**	20,220

Gains less losses from financial investments

	2015 HK$m	2014 HK$m
Gain on partial disposal of investment in Industrial Bank	**10,636**	–
Gain on sale of investment in Bank of Shanghai	**–**	3,320
Gains on disposal of other available-for-sale securities	**983**	1,288
Impairment of available-for-sale equity investments	**(8)**	(2,219)
Gains less losses from financial investments	**11,611**	2,389

2014 included an impairment charge of HK$2,103m on our investment in Industrial Bank.

Other operating income

	2015 HK$m	2014 HK$m
Gain on 150th anniversary banknotes issuance	**693**	–
Movement in present value of in-force insurance business	**4,689**	3,581
Gains on investment properties	**480**	670
Gain on disposal of property, plant and equipment, and assets held for sale	**134**	61
Gain on disposal of subsidiaries, associates, joint ventures and business portfolios	**23**	104
Rental income from investment properties	**404**	422
Loss on reclassification of Techcom Bank	**–**	(251)
Other	**4,016**	3,915
Other operating income	**10,439**	8,502

In 2015, the Bank issued commemorative banknotes to celebrate its 150th anniversary, recognising a gain on banknotes issuance. There was a corresponding increase in operating expenses, reflecting charitable donations and other expenses in relation to the banknotes issuance.

Insurance income

Included in the net operating income are the following revenues earned by the insurance business:

	2015 HK$m	2014 HK$m
Net interest income	**10,486**	9,439
Net fee income	**1,941**	2,083
Net trading loss	**(656)**	(512)
Net income/(loss) from financial instruments designated at fair value	**(2,783)**	4,159
Net insurance premium income	**52,593**	57,307
Movement in present value of in-force business	**4,689**	3,581
Other operating income	**760**	173
	67,030	76,230
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(52,431)**	(60,182)
Total insurance income	**14,599**	16,048

Net interest income increased by 11% from growth in the debt securities portfolio, reflecting net inflows from new and renewal life insurance premiums.

A net loss from financial instruments designated at fair value was recorded in 2015, reflecting the unfavourable equity market performance in the second half of 2015. To the extent that revaluation is attributable to policyholders, there is an offsetting movement reported under 'Net insurance claims and benefits paid and movement in liabilities to policyholders'.

Net insurance premium income decreased by 8%, mainly in Hong Kong due to a change in sales mix, with a corresponding decrease in 'Net insurance claims and benefits paid and movement in liabilities to policyholders'.

The movement in present value of in-force business increased by HK$1,108m, mainly due to a favourable interest rate assumption update in Hong Kong in 2015, with a corresponding increase in 'Net insurance claims and benefits paid and movement in liabilities to policyholders'. The increase was partly offset by a decrease in the value of new business as a result of the change in sales mix.

Other operating income was higher largely due to a gain on disposal of available-for-sale securities, which resulted in a corresponding increase in 'Net insurance claims and benefits paid and movements in liabilities to policyholders'.

Financial Review (continued)

Loan impairment charges and other credit risk provisions

	2015 HK$m	2014 HK$m
Individually assessed impairment charges		
New charges	**4,011**	4,202
Releases	**(1,390)**	(1,420)
Recoveries	**(305)**	(156)
	2,316	2,626
Collectively assessed impairment charges	**2,656**	2,272
Other credit risk provisions	**102**	27
Loan impairment charges and other credit risk provisions	**5,074**	4,925

Operating expenses

	2015 HK$m	2014 HK$m
Employee compensation and benefits	**41,126**	38,894
General and administrative expenses	**29,883**	28,278
Depreciation of property plant and equipment	**4,380**	4,107
Amortisation and impairment of intangible assets	**1,602**	1,671
	76,991	72,950

	2015 %	2014 %
Cost efficiency ratio	**42.0**	42.1

Employee compensation and benefits increased by HK$2,232m, reflecting wage inflation and higher termination benefits, coupled with higher average headcount to support business growth and regulatory programmes and compliance.

General and administrative expenses increased by HK$1,605m mainly due to increased investment in regulatory programmes and compliance, and also included charitable donations and other expenses in relation to the 150th anniversary banknotes issuance.

Operating expenses *(continued)*

Staff numbers by region (full time equivalent)	At 31 December	
	2015	2014
Hong Kong:		
The Bank and wholly-owned subsidiaries	**21,112**	21,153
Hang Seng Bank Hong Kong	**8,244**	8,215
Total Hong Kong	**29,356**	29,368
Rest of Asia-Pacific:		
Australia	**1,658**	1,682
Mainland China	**8,955**	9,106
Malaysia	**4,652**	4,665
India	**4,610**	4,737
Indonesia	**5,413**	5,496
Singapore	**3,189**	3,077
Taiwan	**2,111**	2,320
Others	**7,608**	7,843
Total Rest of Asia-Pacific	**38,196**	38,926
Total	**67,552**	68,294

Tax expense

The tax expense in the consolidated income statement comprises:

	2015 HK$m	2014 HK$m
Current income tax		
Hong Kong taxation	**9,871**	8,862
Overseas taxation	**8,295**	8,696
Deferred taxation	**(870)**	1,454
	17,296	19,012
Effective tax rate	**14.7%**	17.1%

The lower effective tax rate in 2015 was largely due to the non-taxable gain from the partial disposal of investment in Industrial Bank in 2015.

Assets

	2015		2014	
	HK$m	**%**	HK$m	%
Cash and sight balances at central bank	**151,103**	**2.2**	156,475	2.3
Reverse repurchase agreements – non-trading	**212,779**	**3.2**	218,901	3.3
Placings with and advances to banks	**421,221**	**6.3**	488,313	7.3
Loans and advances to customers	**2,762,290**	**41.0**	2,815,216	42.3
Financial investments	**1,716,046**	**25.5**	1,456,493	21.9
Other[1]	**1,470,060**	**21.8**	1,526,694	22.9
	6,733,499	**100.0**	6,662,092	100.0

1 *Excluding Hong Kong Government certificates of indebtedness.*

Gross loans and advances to customers in Hong Kong increased by HK$19bn, or 1%, during 2015, largely from growth in residential mortgage lending of HK$33bn and other personal lending of HK$10bn, partly offset by a decrease of HK$25bn in corporate and commercial lending.

In the Rest of Asia-Pacific, gross loans and advances to customers decreased by HK$71bn, or 6%, due to an unfavourable foreign exchange impact of HK$85bn. Excluding the impact from foreign exchange, gross customer advances increased by HK$14bn, mainly in residential mortgage from business growth in mainland China and Australia.

Financial Review (continued)

Customer accounts

Customer accounts by type	2015 HK$m	2014 HK$m
Current accounts	**949,169**	919,343
Savings accounts	**2,645,151**	2,379,651
Other deposit accounts	**1,045,756**	1,180,998
Total	**4,640,076**	4,479,992
Customer accounts by region		
Hong Kong excluding Hang Seng Bank	**2,361,789**	2,173,472
Hang Seng Bank Hong Kong	**905,255**	844,537
Rest of Asia-Pacific	**1,373,032**	1,461,983
Total	**4,640,076**	4,479,992

	2015 %	2014 %
Advances-to-deposits ratio	**59.5**	62.8

Customer accounts increased by HK$160bn, notably in Hong Kong.

Equity

Equity increased by HK$28bn, or 5%, to HK$636bn. The increase came from retained profits and an increase in the property revaluation reserve. These were offset by decreases in foreign exchange and available-for-sale reserves.

Risk Report

Risk Management

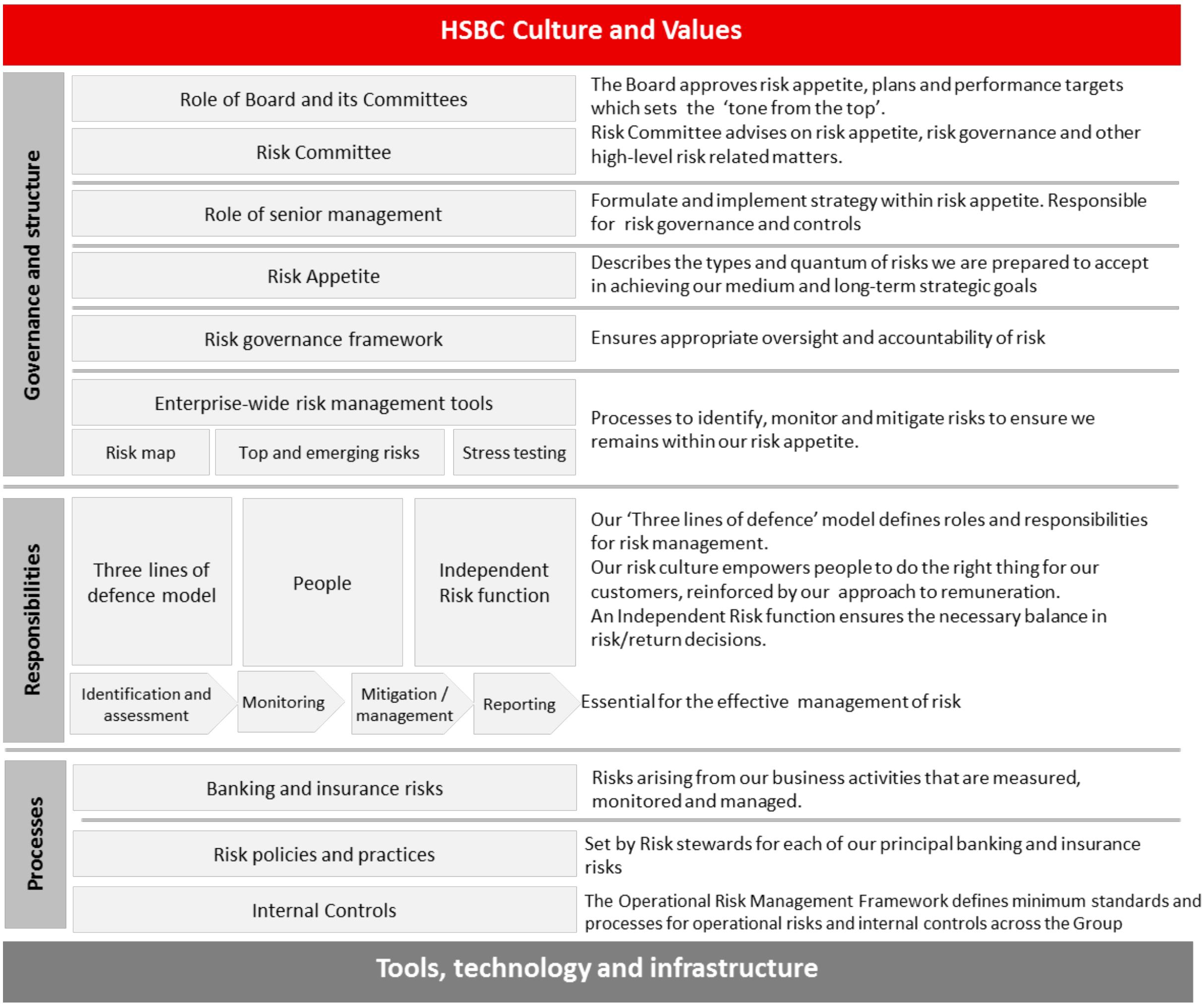
(Unaudited)

All the group's activities involve to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks.

As a provider of banking and financial services, we actively manage risk as a core part of our day-to-day activities.

Risk management framework

The HSBC Group Head Office formulates high-level risk management policies for the HSBC Group worldwide. We employ a risk management framework at all levels of the organisation, underpinned by a strong risk culture and reinforced by HSBC Values and our Global Standards. This is set out below.



Risk governance structure

Robust risk governance and accountability are embedded throughout the Group through an established framework that ensures appropriate oversight of, and accountability for, the effective management of risk at all levels of the organisation and across all risk types. The consistency of governance structures across HSBC is enforced through risk management committees and adherence to consistent standards and risk management policies.

The Board has ultimate responsibility for approving the group's risk appetite and the effective management of risk. The group's Risk Committee advises the Board on risk appetite and its alignment with strategy, risk governance and internal controls, and high-level risk related matters.

Executive accountability for the ongoing monitoring, assessment and management of the risk environment and the effectiveness of our risk management policies resides with the Risk Management Committee. Day-to-day risk management activities are the responsibility of senior managers of individual businesses, supported by global functions as described under 'Three lines of defence' on page 25.

Risk appetite

The group's Risk Appetite Statement ('RAS') is the written articulation of the aggregated level and types of risk that we are willing to accept in our business activities in order to achieve our medium to long-term business objectives. It is a key component of our management of risk and is reviewed on an ongoing basis, with formal approval from the Board on an annual basis on the recommendation of the group's Risk Committee.

The group's actual risk appetite position is reported to the group's Risk Management Committee ('RMC') on a monthly basis to enable senior management to monitor the risk profile and guide business activities in order to balance risk and return, allowing risks to be promptly identified and mitigated, and inform risk-adjusted remuneration to drive a strong risk culture across the group.

The RAS is established and monitored as part of the Global Risk Appetite Framework ('GRAF'), which provides a globally consistent and structured approach to the management, measurement and control of risk by detailing the processes, governance and other features of how risk appetite is cascaded to drive day-to-day decision-making through policies, limits and the control framework.

Risk appetite informs the strategic and financial planning process, defining the desired forward-looking risk profile of the group. It is also embedded in other enterprise risk tools such as top and emerging risks and stress testing, to ensure consistency in risk management. Global businesses and strategic countries are required to have their own RASs, which are subject to assurance to ensure they remain directionally aligned to the group's. All RASs and business activities are guided and underpinned by a set of qualitative principles. Additionally, quantitative metrics are defined along with appetite and tolerance thresholds for ten risk areas.

Enterprise-wide risk management tools

The following processes to identify, manage and mitigate risks are integral to risk management at HSBC, ensuring that we remain within our risk appetite.

Risk map

The risk map process provides a point-in-time view of the risk profile of the group across a suite of risk categories, including our material banking risks and insurance risks (see page 28). It assesses the potential for these risks to materially affect our financial results, reputation or business sustainability on current and projected bases.

The risks presented on the risk map are regularly assessed through our risk appetite profile, are stress tested and, where thematic issues arise, are considered for classification as top or emerging risks.

Top and emerging risks

Identifying, managing and monitoring risks are integral to our approach to risk management. Our top and emerging risks process provides a forward-looking view of those risks which have the potential to threaten the execution of our strategy and our global operations. Top and emerging risks are generally described thematically, and may have an impact across multiple risk map categories, global businesses or countries. We define a 'top risk' as a thematic issue arising across any combination of risk map categories, countries or global businesses which has the potential to have a material effect on the group's financial results, reputation or long-term business model, and which may form and crystallise between six months and one year. The risk impact may be well understood by senior management, with some mitigating actions already in place. Stress tests of varying granularity may also have been carried out to assess the effect.

An 'emerging risk' is defined as a thematic issue that has large unknown components which may form and crystallise beyond a one year time horizon. If it were to materialise, it could have a significant material effect on a combination of the group's long-term strategy, profitability and reputation. Existing management action plans are likely to be minimal, reflecting the uncertain nature of these risks at this stage. Some high-level analysis and/or stress testing may have been carried out to assess the impact.

Our top and emerging risk framework enables us to identify and manage current and forward-looking risks to ensure our risk appetite remains appropriate. The ongoing assessment of our top and emerging risks is informed by a comprehensive suite of risk factors (see page 26) and the results of our stress testing programme. When our top and emerging risks result in our risk appetite being exceeded, or have the potential to exceed, we take steps to mitigate them, including reducing our exposure to areas of stress.

Stress testing

Our stress testing and scenario analysis programme examines the sensitivities of our capital plans and unplanned demand for regulatory capital under a number of scenarios and ensures that top and emerging risks are appropriately considered. These scenarios include, but are not limited to, adverse macroeconomic events, failures at country, sector and counterparty levels, geopolitical occurrences and a variety of projected major operational risk events. The group's Risk Committee is informed and consulted on the group's stress testing activities, as appropriate.

The development of macroeconomic scenarios is a critical part of the process. Potential scenarios are defined and generated by a panel of economic experts from various global teams, including Risk and Finance. Scenarios are translated into financial impacts, such as on our forecast profitability and risk weighted assets ('RWAs'), using a suite of stress testing models and methodologies. Models are subject to independent model review and go through a process of validation and approval. Model overlays may be considered where necessary.

Stress testing results are subject to a review and challenge process at regional, global business and Group levels and action plans are developed to mitigate identified risks. The extent to which these action plans would be implemented in the event of particular scenarios occurring depends on senior management's evaluation of the risks and their potential consequences, taking into account the group's risk appetite.

In addition to the Group-wide risk scenarios, the group conducts regular macroeconomic and event-driven scenario analyses specific to its region. We also participate in local regulatory stress testing programmes, where required.

Stress testing is applied to risks such as market risk, liquidity and funding risk and credit risk to evaluate the potential effects of stress scenarios on portfolio values, structural long-term funding positions, income or capital.

Reverse stress testing is run annually on both Group and, where required, subsidiary entity bases. This is conducted by assuming the business model is non-viable and works backwards to identify a range of occurrences that could bring that event about. Non-viability might occur before the group's capital is depleted, and could result from a variety of events, including idiosyncratic or systemic events or combinations thereof. It could imply failure of the group's holding company or one of its major subsidiaries. Reverse stress testing is used to strengthen our resilience by identifying potential stresses and vulnerabilities which the group might face and helping to inform early-warning triggers, management actions and contingency plans designed to mitigate their effect, were they to occur.

Responsibilities

Three lines of defence

We use the three lines of defence model to underpin our approach to strong risk management. It defines who is responsible to do what to identify, assess, measure, manage, monitor, and mitigate risks, encouraging collaboration and enabling efficient coordination of risk and control activities.

People

All employees are required to identify, assess and manage risk within the scope of their assigned responsibilities and, as such, they are critical to the effectiveness of the three lines of defence.

Clear and consistent employee communication on risk conveys strategic messages and sets the tone from senior leadership. A suite of mandatory training on critical risk and compliance topics is deployed to embed skills and understanding and strengthen the risk culture within HSBC. It reinforces the attitude to risk in the behaviour expected of employees, as described in our risk policies. The training is updated regularly, describing technical aspects of the various risks assumed by the group and how they should be managed effectively. Staff are supported in their roles by a disclosure line which enables them to raise concerns confidentially.

Our risk culture is reinforced by our approach to remuneration. Individual awards, including those for executives, are based on compliance with HSBC Values and the achievement of financial and non-financial objectives which are aligned to our risk appetite and global strategy.

Risk Report (continued)

Independent Risk function

The group's Risk function, headed by the group's Chief Risk Officer, is responsible for enterprise-wide risk oversight. This includes establishing and monitoring of risk profiles and forward-looking risk identification and management. The group's Risk function, which is independent from the sales and trading functions of our businesses, has functional responsibility for risk management in support of the group's global businesses. This independence ensures the necessary balance in risk/return decisions.

Risk factors

We have identified a comprehensive suite of risk factors which covers the broad range of risks to which our businesses are exposed.

A number of the risk factors have the potential to affect the results of our operations or financial condition, but may not necessarily be deemed as top or emerging risks. However, they inform the ongoing assessment of our top and emerging risks which may result in our risk appetite being revised. The risk factors are:

Macroeconomic and geopolitical risk

- Current economic and market conditions may adversely affect our results.
- We are subject to political and economic risks in the countries in which we operate, including the risk of government intervention.
- We may suffer adverse effects as a result of the renewed economic and sovereign debt tensions in the eurozone.
- Changes in foreign currency exchange rates may affect our results.

Macro-prudential, regulatory and legal risks to our business model

- Failure to implement our obligations under the deferred prosecution agreements could have a material adverse effect on our results and operations.
- Failure to comply with certain regulatory requirements would have a material adverse effect on our results and operations.
- Failure to meet the requirements of regulatory stress tests could have a material adverse effect on our capital position, operations, results and future prospects.
- We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand.
- Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could have a material adverse effect on our operations, financial condition and prospects.
- We are subject to tax-related risks in the countries in which we operate which could have a material adverse effect on our operating results.

Risks related to our business, business operations, governance and internal control systems

- The delivery of our strategic priorities is subject to execution risk.
- We may not achieve all the expected benefits of our strategic initiatives.
- We operate in markets that are highly competitive.
- Our risk management measures may not be successful.
- Operational risks are inherent in our business.
- Our operations are subject to the threat of fraudulent activity.
- Our operations are subject to disruption from the external environment.
- Our operations utilise third-party suppliers and service providers.
- Our operations are highly dependent on our information technology systems.
- We may not be able to meet regulatory requests for data.
- Our operations have inherent reputational risk.
- We may suffer losses due to employee misconduct.
- We rely on recruiting, retaining and developing appropriate senior management and skilled personnel.
- Our Financial Statements are based in part on judgements, estimates and assumptions which are subject to uncertainty.
- The group could incur losses or be required to hold additional capital as a result of model limitations or failure.
- Third parties may use us as a conduit for illegal activities without our knowledge, which could have a material adverse effect on us.
- We have significant exposure to counterparty risk.
- Market fluctuations may reduce our income or the value of our portfolios.
- Liquidity, or ready access to funds, is essential to our businesses.
- Any reduction in the credit rating assigned to HSBC Holdings plc, any subsidiaries of HSBC Holdings plc or any of their respective debt securities could increase the cost or decrease the availability of our funding and adversely affect our liquidity position and interest margins.
- Risks concerning borrower credit quality are inherent in our businesses.
- Our insurance business is subject to risks relating to insurance claim rates and changes in insurance customer behaviour.
- We may be required to make substantial contributions to our pension plans.

Risk Report (continued)

Risks managed by HSBC

The principal risks associated with our banking and insurance manufacturing operations are described in the tables below.

Description of risks - banking operations
(Audited)

Risks	Arising from	Measurement, monitoring and management of risk
Credit risk		
The risk of financial loss if a customer or counterparty fails to meet an obligation under a contract.	• Credit risk arises principally from direct lending, trade finance and leasing business, but also from certain other products such as guarantees and derivatives.	Credit risk: • is measured as the amount which could be lost if a customer or counterparty fails to make repayments. In the case of derivatives, the measurement of exposure takes into account the current mark to market value of the contract and the expected potential change in that value over time caused by movements in market rates; • is monitored within limits approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the group could be subjected should the customer or counterparty fail to perform its contractual obligations; and • is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.
Liquidity and funding risk		
The risk that we do not have sufficient financial resources to meet our obligations as they fall due or that we can only do so at excessive cost.	• Liquidity risk arises from mismatches in the timing of cash flows. • Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.	Liquidity and funding risk: • is measured using internal metrics including stressed operational cash flow projections, coverage ratio and advances to core funding ratios; • is monitored against the Group's liquidity and funding risk framework and overseen by regional Asset and Liability Management Committees ('ALCO's), Group ALCO and the Risk Management Meeting of Group Management Board ('GMB'); and • is managed on a stand-alone basis with no reliance on any Group entity (unless pre-committed) or central bank unless this represents routine established market practice.
Market risk		
The risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.	Exposure to market risk is separated into two portfolios: • Trading portfolios comprise positions arising from market-making and warehousing of customer derived positions. • Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held to maturity, and exposures arising from our insurance operations.	Market risk: • is measured in terms of value at risk, which is used to estimate potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence, augmented with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables; • is monitored using measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange which are applied to the market risk positions within each risk type; and • is managed using risk limits approved by the Risk Management Committee for the group. These limits are allocated across business lines and to the group's operating entities.

Risks	Arising from	Measurement, monitoring and management of risk
Operational risk		
The risk to achieving our strategy or objectives as a result of inadequate or failed internal processes, people and systems or from external events.	Operational risk arises from day to day operations or external events, and is relevant to every aspect of our business.	Operational risk: • is measured using both the scenario analysis process and the risk and control assessment process, which assess the level of risk and effectiveness of controls; • is monitored using key indicators and other internal control activities; and • is primarily managed by global business and functional managers. They identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls using the operational risk management framework. The Global Operational Risk function is responsible for the framework and for overseeing the management of operational risks within businesses and functions.
Compliance risk		
The risk that we fail to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice, and incur fines and penalties and suffer damage to our business as a consequence. *This includes our obligations under the Deferred Prosecution Agreement (DPA) and related agreements and consent orders. This is discussed further in note 52.*	Compliance risk is part of operational risk, and arises from rules, regulations, other standards and Group policies, including those relating to anti-money laundering, anti-bribery and corruption, counter-terrorist and proliferation financing, sanctions compliance and conduct of business.	Compliance risk: • is measured by reference to identified metrics, incident assessments (whether affecting the Group or the wider industry), regulatory feedback and the judgement and assessment of compliance officers in our global businesses, regions and functions; • is monitored against our compliance risk assessments and metrics, the results of the monitoring and control activities of the second line of defence functions, including the Financial Crime Compliance and Regulatory Compliance sub-functions, and the results of internal and external audits and regulatory inspections; and • is managed by establishing and communicating appropriate policies and procedures, training employees in them, and monitoring activity to assure their observance. Proactive risk control and/or remediation work is undertaken where required.
Other material risks		
Reputational risk		
The risk that illegal, unethical or inappropriate behaviour by the group itself, members of staff or clients or representatives of the group will damage our reputation, leading, potentially, to a loss of business, fines or penalties.	Reputational risk encompasses negative reaction not only to activities which may be illegal or against regulations, but also to activities that may be counter to societal standards, values and expectations. It arises from a wide variety of causes, including how we conduct our business and the way in which clients to whom we provide financial services, and bodies who represent us, conduct themselves.	Reputational risk: • is measured by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees; • is monitored through a reputational risk management framework, taking into account the results of the compliance risk monitoring activity; and • is managed by every member of staff and is covered by a number of policies and guidelines. There is a clear structure of committees and individuals charged with mitigating reputational risk, including the Group Reputational Risk Policy Committee and regional/business equivalents.

Risk Report (continued)

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

Description of risks - insurance manufacturing operations

Risks	Arising from	Measurement, monitoring and management of risk
Insurance risk		
The risk that, over time, the cost of acquiring and administering an insurance contract and paying claims and benefits may exceed the aggregate amount of premiums received and investment income.	The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.	Insurance risk: • is measured in terms of life insurance liabilities; • is monitored by the Risk Management Committee of the Insurance operations, which checks the risk profile against the risk appetite for insurance business; and • is managed both centrally and locally using product design, underwriting, reinsurance and claims-handling procedures.
Financial risks		
Our ability to effectively match the liabilities arising under insurance contracts with the asset portfolios that back them are contingent on the management of financial risks such as market, credit and liquidity risks, and the extent to which these risks are borne by the policyholders. *Contracts with discretionary participation features share the performance of the underlying assets between policyholders and the shareholder in line with the type of contract and the specific contract terms.*	Exposure to financial risks arises from: • market risk of changes in the fair values of financial assets or their future cash flows from fluctuations in variables such as interest rates, foreign exchange rates and equity prices; • credit risk and the potential for financial loss following the default of third parties in meeting their obligations; and • liquidity risk of entities not being able to make payments to policyholders as they fall due as there are insufficient assets that can be realised as cash within the required timeframe.	Financial risks: • are measured separately for each type of risk: – market risks are measured in terms of exposure to fluctuations in key financial variables; – credit risk is measured as the amount which could be lost if a counterparty fails to make repayments; and – liquidity risk is measured using internal metrics including stressed operational cash flow projections; • are monitored within limits approved by individuals within a framework of delegated authorities; • are managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers. Subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates and equity prices to the extent that the market exposure cannot be managed by using any discretionary participation (or bonus) features within the policy contracts they issue; and • can be mitigated through sharing of risk with policyholders under the discretionary participation features for participating products.

Exposure to risks arising from the business activities of global businesses (Unaudited)

The chart below provides a high level guide to how the group's business activities are reflected in our risk measures and in our balance sheet.

The assets and liabilities indicate the contribution each business makes to the balance sheet, while RWAs illustrate the relative size of the risks incurred in respect of each business.

The Hongkong and Shanghai Banking Corporation Limited

Global business	**RBWM**	**CMB**	**GB&M**	**GPB**	**Other**
Business activities	• Deposits • Accounts services • Credit and lending • Asset management • Wealth solutions and financial planning • Broking • Life insurance manufacturing	• Deposits • Payments and cash management • Credit and lending • Global trade and receivable finance • Global markets (via GB&M) • Capital finance (via GB&M) • Insurance and investments	• Deposits • Payments and cash management • Balance sheet management • Credit and lending • Asset and trade finance • Corporate finance • Global markets • Capital finance • Securities services	• Deposits • Account services • Credit and lending • Asset management • Financial advisory • Broking • Corporate finance (via GB&M) • Alternative investments	• The Bank's central operations
Balance sheet[1]	HK$bn • Assets 1,337 • Customer accounts 2,353	HK$bn • Assets 1,223 • Customer accounts 1,280	HK$bn • Assets 4,161 • Customer accounts 783	HK$bn • Assets 112 • Customer accounts 222	HK$bn • Assets 121 • Customer accounts 2
RWAs	HK$bn • Credit risk 270 • Operational risk 64	HK$bn • Credit risk 751 • Counterparty credit risk – • Operational risk 61	HK$bn • Credit risk 646 • Counterparty credit risk 175 • Operational risk 151 • Market risk 101	HK$bn • Credit risk 21 • Counterparty credit risk 2 • Operational risk 3	HK$bn • Credit risk 254 • Operational risk 20
Risk Profile	Liquidity and funding risk, Reputational risk and Insurance risk. The latter is predominantly in RBWM and CMB.				

1 *The sum of balances presented does not agree to the consolidated financial statements, because balances between global businesses are not eliminated here.*

Credit Risk

(Audited)

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.

Both the group's Risk Management Committee ('RMC') and HSBC Group Head Office receive regular reports on credit exposures. These include information on large credit exposures, concentrations, industry exposures, levels of impairment provisioning and country exposures.

RMC has the responsibility for risk approval authorities and approving definitive risk policies and controls. It monitors risk inherent to the financial services business, receives reports, determines action to be taken and reviews the efficacy of the risk management framework.

The Executive Committee ('EXCO') and RMC are supported by a dedicated group risk function headed by the Chief Risk Officer, who is a member of both EXCO and RMC and reports to the Chief Executive.

The Risk Committee also has responsibility for oversight and advice to the Board on risk matters. The key responsibilities of the Risk Committee in this regard include preparing advice to the Board on the overall risk appetite tolerance and strategy within the group, and seeking such assurance as it may deem appropriate that account has been taken of the current and prospective macroeconomic and financial environment. The Risk Committee is also responsible for the periodic review of the effectiveness of the internal control and risk management frameworks and advising the Board on all high level risk matters. The Risk Committee approves the appointment and removal of the group Chief Risk Officer.

(i) Credit exposure

Maximum exposure to credit risk
(Audited)

Our credit exposure is spread across a broad range of asset classes, including derivatives, trading assets, loans and advances to customers, placings with 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.

Maximum exposure to credit risk before collateral held or other credit enhancements

	2015 HK$m	2014 HK$m
Cash and sight balances at central banks	**151,103**	156,475
Items in the course of collection from other banks	**25,020**	21,122
Hong Kong Government certificates of indebtedness	**220,184**	214,654
Trading assets	**257,851**	365,846
Debt securities	**178,358**	231,734
Treasury and other eligible bills	**43,607**	102,028
Other	**35,886**	32,084
Derivatives	**380,955**	389,934
Financial assets designated at fair value	**18,825**	17,238
Debt securities	**17,755**	17,238
Treasury bills	**1,070**	–
Reverse repurchase agreements – non-trading	**212,779**	218,901
Placings with and advances to banks	**421,221**	488,313
Loans and advances to customers	**2,762,290**	2,815,216
Personal	**1,026,544**	1,002,613
Corporate and commercial	**1,627,598**	1,704,184
Financial (non-bank financial institutions)	**108,148**	108,419
Financial investments	**1,706,981**	1,407,362
Debt securities	**1,015,345**	862,826
Treasury and other eligible bills	**691,636**	544,536
Amounts due from Group companies	**244,396**	191,694
Other assets	**76,035**	82,000
Acceptances and endorsements	**31,480**	31,200
Other	**44,555**	50,800
Financial guarantees and other credit-related contingent liabilities	**63,812**	61,666
Loan commitments and other credit-related commitments[1]	**2,545,291**	2,265,453
At 31 December	**9,086,743**	8,695,874

1 *Includes both revocable and irrevocable commitments.*

Total exposure to credit risk remained broadly unchanged in 2015, with loans and advances remaining to be the largest element.

(ii) Credit quality of financial instruments
(Audited)

Five broad classifications describe the credit quality of the group's lending and debt securities portfolios. Each of these classifications encompasses 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.

Risk Report (continued)

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

	Debt securities and other bills	Wholesale lending and derivatives		Retail lending	
	External credit rating	Internal credit rating	12 month probability of default %	Internal credit rating[1]	Expected loss %
Quality Classification					
Strong	A– and above	CRR[2]1 to CRR2	0 – 0.169	EL[3]1 to EL2	0 – 0.999
Good	BBB+ to BBB-	CRR3	0.170 – 0.740	EL3	1.000 – 4.999
Satisfactory	BB+ to B, and unrated	CRR4 to CRR5	0.741 – 4.914	EL4 to EL5	5.000 – 19.999
Sub-standard	B- to C	CRR6 to CRR8	4.915 – 99.999	EL6 to EL8	20.000 – 99.999
Impaired	Default	CRR9 to CRR10	100	EL9 to EL10	100+ or defaulted[4]

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 page 37, 'Ageing analysis of past due but not yet impaired financial instruments').*

2 *Customer risk rating.*

3 *Expected loss.*

4 *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. Please refer to note 48 for definitions of PD and LGD.*

Quality classification definitions
(Audited)

- 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.
- Good: Exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.
- Satisfactory: Exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minor following the adoption of recovery processes.
- Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.
- Impaired: Exposures have been assessed, individually or collectively, as impaired. The group observes the convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL 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.

Granular risk rating scales
(Audited)

The CRR 10-grade scale summarises a more granular underlying 23-grade scale of obligor probability of default ('PD'). All HSBC wholesale customers are rated using the 10 or 23-grade scale, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

The EL 10-grade scale for retail business summarises a more granular underlying EL scale for these customer segments; this combines obligor and facility/product risk factors in a composite measure. 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 extends 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.

Distribution of financial instruments by credit quality
(Audited)

	Neither past due nor impaired							
31 December 2015	**Strong HK$m**	**Good HK$m**	**Satisfactory 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	**23,122**	**138**	**1,758**	**2**				**25,020**
Trading assets	**196,284**	**33,923**	**27,548**	**96**				**257,851**
– treasury and other eligible bills	**40,607**	**2,865**	**135**	**–**				**43,607**
– debt securities	**134,203**	**25,827**	**18,232**	**96**				**178,358**
– loans and advances to banks	**13,772**	**3,045**	**34**	**–**				**16,851**
– loans and advances to customers	**7,702**	**2,186**	**9,147**	**–**				**19,035**
Derivatives	**331,119**	**32,973**	**16,442**	**421**				**380,955**
Financial assets designated at fair value	**16,119**	**635**	**2,071**	**–**				**18,825**
– treasury bills	**1,070**	**–**	**–**	**–**				**1,070**
– debt securities	**15,049**	**635**	**2,071**	**–**				**17,755**
Reverse repurchase agreements – non-trading	**152,464**	**33,441**	**26,842**	**32**	**–**	**–**	**–**	**212,779**
Placings with and advances to banks held at amortised cost	**385,484**	**32,197**	**3,050**	**487**	**3**	**–**	**–**	**421,221**
Loans and advances to customers held at amortised cost	**1,381,933**	**737,571**	**585,852**	**23,674**	**26,386**	**18,403**	**(11,529)**	**2,762,290**
– personal	**882,961**	**75,931**	**44,963**	**729**	**19,940**	**3,998**	**(1,978)**	**1,026,544**
– corporate and commercial	**454,541**	**619,577**	**520,073**	**22,424**	**6,122**	**14,315**	**(9,454)**	**1,627,598**
– financial (non-bank financial institutions)	**44,431**	**42,063**	**20,816**	**521**	**324**	**90**	**(97)**	**108,148**
Financial investments	**1,578,353**	**80,329**	**48,299**	**–**	**–**	**–**	**–**	**1,706,981**
– treasury and other eligible bills	**666,028**	**17,435**	**8,173**	**–**	**–**	**–**	**–**	**691,636**
– debt securities	**912,325**	**62,894**	**40,126**	**–**	**–**	**–**	**–**	**1,015,345**
Other assets	**24,151**	**20,765**	**29,800**	**1,051**	**162**	**106**		**76,035**
– acceptances and endorsements	**5,435**	**14,358**	**10,678**	**971**	**7**	**31**		**31,480**
– other	**18,716**	**6,407**	**19,122**	**80**	**155**	**75**		**44,555**
Total	**4,089,029**	**971,972**	**741,662**	**25,763**	**26,551**	**18,509**	**(11,529)**	**5,861,957**

Risk Report (continued)

31 December 2014	Neither past due nor impaired: Strong HK$m	Good HK$m	Satisfactory 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	19,595	156	1,371	–				21,122
Trading assets	280,265	53,600	31,856	125				365,846
– treasury and other eligible bills	92,277	8,199	1,552	–				102,028
– debt securities	175,655	34,002	21,952	125				231,734
– loans and advances to banks	8,589	5,460	280	–				14,329
– loans and advances to customers	3,744	5,939	8,072	–				17,755
Derivatives	319,670	55,641	14,330	293				389,934
Financial assets designated at fair value	14,621	743	1,874	–				17,238
– treasury bills	–	–	–	–				–
– debt securities	14,621	743	1,874	–				17,238
Reverse repurchase agreements – non-trading	152,021	30,060	36,820	–	–	–	–	218,901
Placings with and advances to banks held at amortised cost	425,580	56,362	4,096	2,273	2	–	–	488,313
Loans and advances to customers held at amortised cost	1,362,131	790,075	598,783	25,821	33,039	15,887	(10,520)	2,815,216
– personal	863,201	75,479	39,158	597	22,339	3,808	(1,969)	1,002,613
– corporate and commercial	453,699	674,465	538,984	24,954	8,545	11,984	(8,447)	1,704,184
– financial (non-bank financial institutions)	45,231	40,131	20,641	270	2,155	95	(104)	108,419
Financial investments	1,272,781	83,383	51,192	–	–	6	–	1,407,362
– treasury and other eligible bills	507,519	21,814	15,203	–	–	–	–	544,536
– debt securities	765,262	61,569	35,989	–	–	6	–	862,826
Other assets	31,720	19,333	29,411	1,144	287	105		82,000
– acceptances and endorsements	5,400	12,221	12,528	1,002	5	44		31,200
– other	26,320	7,112	16,883	142	282	61		50,800
Total	3,878,384	1,089,353	769,733	29,656	33,328	15,998	(10,520)	5,805,932

1 *The above table does not include balances due from Group companies.*

(iii)Ageing analysis of past due but not impaired financial instruments
(Audited)

The amounts in the following table reflect exposures designated as past due but not impaired. Examples of exposures designated as past due but not impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment, and short-term trade facilities past due more than 90 days for technical reasons, such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

	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 2015						
Loans and advances to customers held at amortised cost[1]	**20,868**	**4,182**	**1,321**	**15**	**–**	**26,386**
– personal	**15,161**	**3,594**	**1,185**	**–**	**–**	**19,940**
– corporate and commercial	**5,385**	**586**	**136**	**15**	**–**	**6,122**
– financial (non-bank financial institutions)	**322**	**2**	**–**	**–**	**–**	**324**
Placings with and advances to banks held at amortised cost	**3**	**–**	**–**	**–**	**–**	**3**
Other assets	**66**	**26**	**27**	**33**	**10**	**162**
	20,937	**4,208**	**1,348**	**48**	**10**	**26,551**
31 December 2014						
Loans and advances to customers held at amortised cost[1]	27,445	4,217	1,370	7	–	33,039
– personal	17,433	3,689	1,211	6	–	22,339
– corporate and commercial	7,938	447	159	1	–	8,545
– financial (non-bank financial institutions)	2,074	81	–	–	–	2,155
Placings with and advances to banks held at amortised cost	2	–	–	–	–	2
Other assets	131	30	26	42	58	287
	27,578	4,247	1,396	49	58	33,328

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

(iv) Impaired loans and advances
(Audited)

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(e) on the Financial Statements.

Analyses of impairment allowances at 31 December 2015, and the movement of such allowances during the year, are disclosed in note 16 on the Financial Statements.

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

- wholesale loans and advances classified as CRR 9 or CRR 10. These grades are assigned when the bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse to security, or when the customer is past due 90 days or more on any material credit obligation to the group;
- retail loans and advances:
  - classified as EL 9 or EL 10; or
  - classified as EL 1 to EL 8 with 90 days and over past due
- renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment. For loans that are assessed for impairment on a collective basis, the evidence to support reclassification as no longer impaired typically comprises a history of payment performance against the original or revised terms, depending on the nature and volume of renegotiation and the credit risk characteristics surrounding the renegotiation. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case by case basis.

(v) Impairment assessment
(Audited)

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

For details of our impairment policies on loans and advances and financial investments, see notes 3(e) and 3(h) on the Financial Statements.

Impairment and credit risk mitigation

The existence of collateral has an impact when calculating impairment on individually assessed impaired loans. If exposures are secured, the current net realisable value of the collateral will be taken into account when assessing the need for an impairment allowance. No impairment allowance is recognised in cases where all amounts due are expected to be settled in full on realisation of the security.

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

- The historical loss methodology is typically used to calculate collective impairment allowances for secured, or low default portfolios, until the point at which they are individually identified and assessed as impaired. For loans which are collectively assessed using historical loss methodology, the historical loss rate is derived from the average contractual write-off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after the realisation of collateral and receipt of recoveries.
- A roll rate methodology is more commonly adopted for unsecured portfolios when there are sufficient volumes of empirical data to develop robust statistical models.

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

For wholesale collectively assessed loans and secured personal lending, historical loss methodologies are applied to estimate impairment losses which have been incurred but not individually identified. Loss rates are derived from the observed contractual write-off net of recoveries over a defined period of at least 60 months. The net contractual write-off rate is the actual amount of loss experienced after realisation of collateral and receipt of recoveries. These historical loss rates are adjusted by an economic factor which adjusts the historical averages to better represent current economic conditions affecting the portfolio. In order to reflect the likelihood of a loss event not being identified and assessed, an emergence period assumption is applied. This reflects the period between a loss occurring and its identification. The emergence period is estimated by the group, and in some cases by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. A fixed range for the period between a loss occurring and its identification is not defined across the group and as it is assessed empirically on a periodic basis, it may vary over time as these factors change.

(vi) Collateral and other credit enhancements
(Audited)

Loans and advances

Although collateral can be an important mitigant of credit risk, it is the group’s general 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. For other lending, a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default, the bank may use the collateral as a source of repayment.

Depending on its form, collateral can have a significant financial effect in mitigating our exposure to credit risk. The tables below provide a quantification of the value of fixed charges we hold over a borrower’s specific asset (or assets) where we have a history of enforcing, and are able to enforce the collateral in satisfying a debt in the event of the borrower failing to meet its contractual obligations, and can be realised by sale in an established market or where the collateral is cash. The collateral valuation in the tables below excludes 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.

Risk Report (continued)

Personal lending

(Audited)

Residential mortgages including loan commitments by level of collateral

	At 31 December	
	2015	2014
	HK$m	HK$m
Unimpaired loans		
Fully collateralised	**775,823**	769,890
Partially collateralised		
– Greater than 100% LTV (A)	**1,300**	769
– Collateral value on A	**1,199**	625
Not collateralised	**839**	771
	777,962	771,430
Impaired loans		
Fully collateralised	**1,721**	1,987
– Less than 75% LTV	**1,396**	1,704
– 76% to 90% LTV	**267**	249
– 91% to 100% LTV	**58**	34
Partially collateralised		
– Greater than 100% LTV (B)	**64**	52
– Collateral value on B	**50**	35
Not collateralised	**8**	6
	1,793	2,045
Total residential mortgages	**779,755**	773,475

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 are updated on a regular basis and, as a minimum, at intervals of every three years. Valuations are conducted more frequently when market conditions or portfolio performance are subject to significant change or where a loan is identified and assessed as impaired.

Other personal lending

Other personal lending consists primarily of personal loans, overdrafts and credit cards, all of which are generally unsecured, except lending to private banking customers which are generally secured.

Corporate, commercial and financial (non-bank financial institutions) lending

(Audited)

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 level of 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

	At 31 December	
	2015	2014
	HK$m	HK$m
Rated CRR/EL 1 to 7	**314,069**	341,709
Not collateralised	**95,551**	125,131
Fully collateralised	**203,603**	204,177
Partially collateralised (A)	**14,915**	12,401
– collateral value on A	**9,104**	6,989
Rated CRR/EL 8	**45**	233
Not collateralised	**–**	52
Fully collateralised	**37**	179
Partially collateralised (B)	**8**	2
– collateral value on B	**3**	1
Rated CRR/EL 9 to 10	**570**	603
Not collateralised	**395**	365
Fully collateralised	**137**	119
Partially collateralised (C)	**38**	119
– collateral value on C	**22**	41
Total commercial real estate loans and advances	**314,684**	342,545

The collateral included in the table above consist 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).

Risk Report (continued)

Other corporate, commercial and financial (non-bank) loans and advances rated CRR/EL 8 to 10 only, including loan commitments, by level of collateral
(Audited)

	At 31 December 2015 HK$m	2014 HK$m
Rated CRR/EL 8	**1,954**	2,617
Not collateralised	**1,274**	1,842
Fully collateralised	**316**	432
Partially collateralised (A)	**364**	343
– collateral value on A	**131**	132
Rated CRR/EL 9 to 10	**14,197**	11,177
Not collateralised	**6,869**	7,239
Fully collateralised	**3,408**	1,112
Partially collateralised (B)	**3,920**	2,826
– collateral value on B	**1,827**	1,314
Total	**16,151**	13,794

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.

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, and 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 lending activities 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. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

Placings with and advances to banks
(*Audited)*

Placings with and advances to banks, including loan commitments, by level of collateral

	At 31 December 2015 HK$m	2014 HK$m
Rated CRR/EL 1 to 8		
Not collateralised	**415,063**	498,004
Fully collateralised	**13,656**	12,307
Total placings with and advances to banks	**428,719**	510,311

The collateral used in the assessment of the above lending relates primarily to marketable securities. Placings with and advances to banks are typically unsecured.

Derivatives

(Audited)

The International Swaps and Derivatives Association ('ISDA') Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over the counter ('OTC') products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or another pre-agreed termination event occurs. It is common, and our preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institution clients. Please refer to note 44 'Offsetting of financial assets and liabilities' for further details.

Other credit risk exposures

(Audited)

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

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

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 41 'Contingent liabilities and commitments'.

The carrying amount of assets obtained by taking possession of collateral held as security, or calling upon other credit enhancements, are as follows:

	At 31 December	
	2015	2014
	HK$m	HK$m
Residential properties	**104**	80
Commercial and industrial properties	**39**	26
Other assets	**4**	3
	147	109

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.

Risk Report (continued)

Liquidity and Funding Risk

(Audited)

The management of liquidity and funding is primarily undertaken locally (by country) in our operating entities, in compliance with the Group's liquidity and funding risk framework ('LFRF') and with practices and limits set by the GMB through the Risk Management Meeting and approved by the Board. These limits vary according to the depth and liquidity of the markets in which the entities operate. Our general policy is that each defined operating entity should be self-sufficient in funding its own activities. Where transactions exist between operating entities, they are reflected symmetrically in both entities.

As part of the HSBC Group's Asset, Liability and Capital Management ('ALCM') structure, we have established Asset and Liability Management Committees ('ALCOs') at the group and operating entity level. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

The primary responsibility for managing liquidity and funding within the Group's framework and risk appetite resides with the local operating entity ALCO. All operating entities are overseen by the group ALCO, with appropriate escalation of significant issues to the HSBC Group ALCO and the Risk Management Meeting of the GMB.

Operating entities are predominately defined on a country basis to reflect our local management of liquidity and funding. Typically, an operating entity will be defined as a single branch or legal entity. However, to take account of the situation where operations in a country are booked across multiple subsidiaries or branches:

- an operating entity may be defined as a wider sub-consolidated group of legal entities if they are incorporated in the same country, liquidity and funding are freely fungible between the entities and permitted by local regulation, and the definition reflects how liquidity and funding are managed locally; or
- an operating entity may be defined more narrowly as a principal office (branch) of a wider legal entity operating in multiple countries, reflecting the local country management of liquidity and funding.

The Board is ultimately responsible for determining the types and magnitude of liquidity risk that the group is able to take and ensuring that there is an appropriate organisation structure for managing this risk. Under authorities delegated by the Board, the group ALCO is responsible for managing all ALCM issues including liquidity and funding risk management.

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

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

Compliance with liquidity and funding requirements is monitored by local ALCO who report to the group ALCO on a regular basis. This process includes:

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

The management of liquidity and funding risk

Inherent liquidity risk ('ILR') categorisation
(Audited)

We place our operating entities into one of two categories to reflect our assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the host country and factors specific to the operating entities themselves, such as the local market, market share and balance sheet strength. The categorisation involves management judgement and is based on the perceived liquidity risk of an operating entity relative to other entities in the group. The categorisation is intended to reflect the possible impact of a liquidity event, not the probability of an event. The categorisation is part of our risk appetite and is used to determine the prescribed stress scenario that we require our operating entities to be able to withstand and manage.

Core deposits
(Audited)

A key assumption of our internal framework is the classification of customer deposits into core and non-core based on our expectation of the behaviour of these deposits during periods of liquidity stress. This characterisation takes into account the inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer and the size and pricing of the deposit. No deposit is considered to be core in its entirety unless it is contractually collateralising a loan. The core deposit base in each operating entity is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that we use to calculate our principal liquidity risk metrics.

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

- price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;
- size: depositors with total funds above certain monetary thresholds are excluded. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and
- line of business: the element of any deposit remaining after the application of the price and size filter is assessed on the basis of the line of business to which the deposit is associated. The proportion of any customer deposit that can be considered core under this filter is between 35% and 90%.

Repurchase agreements transactions and bank deposits cannot be categorised as core deposits.

Advances to core funding ratio
(Unaudited)

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

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

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

Stressed coverage ratios
(Unaudited)

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

The stressed cash inflows include:

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

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

A stressed coverage ratio of 100% or higher reflects a positive cumulative cash flow under the stress scenario being monitored. Group operating entities are required to maintain a ratio of 100% or greater out to three months under the combined market-wide and HSBC-specific stress scenario defined by the inherent risk categorisation of the operating entity concerned.

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

	Advances to core funding ratio		Stressed one month coverage ratio		Stressed three month coverage ratio	
	2015	2014	**2015**	2014	**2015**	2014
	%	%	**%**	%	**%**	%
Year-end	**76.1**	79.9	**131.6**	120.2	**121.4**	114.2
Maximum	**80.8**	80.2	**131.6**	122.1	**121.4**	116.3
Minimum	**76.1**	77.8	**115.9**	116.7	**112.1**	113.2
Average	**78.3**	79.6	**122.3**	118.4	**116.2**	114.3

Stressed scenario analysis
(Unaudited)

We use a number of standard Group stress scenarios designed to model:

- combined market-wide and HSBC-specific liquidity crisis scenarios; and
- market-wide liquidity crisis scenario.

These scenarios are modelled by all operating entities. The appropriateness of the assumptions for each scenario is reviewed regularly and formally approved by the Risk Management Meeting of the GMB and the Board annually as part of the liquidity and funding risk appetite approval process.

Stressed cash outflows are determined by applying a standard set of prescribed stress assumptions to the Group's cash flow model. Our framework prescribes the use of two market-wide scenarios and three further combined market-wide and HSBC-specific stress scenarios of increasing severity. In addition to our standard stress scenarios, individual operating entities are required to design their own scenarios to reflect specific local market conditions, products and funding bases.

The two combined market-wide and HSBC-specific scenarios model a more severe scenario than the market-wide scenario. The relevant combined market-wide and HSBC-specific stress scenario that an operating entity manages to is based upon its inherent liquidity risk categorisation.

Liquid assets
(Unaudited)

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

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

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

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

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

Internal categorisation	Cash inflow recognised	Asset classes	Eligibility criteria
Level 1	• Within one month	• Central government • Central bank (including confirmed withdrawable reserves) • Supranationals • Multilateral Development Banks • Coins and banknotes	• 0% and 20% risk weighted
Level 2	• Within one month but capped	• Local and regional government • Public sector entities • Secured covered bonds and pass-through ABSs • Gold	• 20% risk weighted
Level 3	• From one to three months	• Unsecured non-financial entity securities • Equities listed on recognised exchanges and within liquid indices	• Internally rated 2.2 CRR or better

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

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

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

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

	At 31 December	
	2015	2014
Liquid assets of the group	**HK$m**	HK$m
Level 1	**1,535,161**	1,330,759
Level 2	**82,908**	73,940
Level 3	**62,303**	67,916
	1,680,372	1,472,615

Wholesale debt monitoring
(Unaudited)

Where wholesale debt term markets are accessed to raise funding, ALCO is required to establish cumulative rolling three-month and 12-month debt maturity limits to ensure no concentration of maturities within these timeframes.

Sources of funding
(Audited)

Our primary sources of funding are customer current accounts and customer savings deposits payable on demand or at short notice. We also access wholesale funding markets by issuing senior secured and unsecured debt securities (publicly and privately) and borrowing from the secured repo markets against high quality collateral, in order to obtain funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local wholesale markets.

Liquidity behaviouralisation
(Unaudited)

Liquidity behaviouralisation is applied to reflect our assessment of the expected period for which we are confident that we will have access to our liabilities, even under a severe liquidity stress scenario, and the expected period for which we must assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour. Liquidity behaviouralisation is reviewed and approved by local ALCOs in compliance with policies set by the Risk Management Meeting of the GMB.

Contingent liquidity risk
(Audited)

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

Currency mismatch
(Audited)

The group allows currency mismatches to provide some flexibility in managing the balance sheet structure and to carry out foreign exchange trading, on the basis that there is sufficient liquidity in the swap market to support currency conversion in periods of stress. The group sets limits on cash flow projection for all material currencies based on liquidity in the swap markets. These limits are approved and monitored by ALCO.

Encumbered and unencumbered assets
(Unaudited)

An asset is defined as encumbered, from a liquidity perspective, if it has been pledged as collateral against an existing liability, and as a result is no longer available to the bank to secure funding, satisfy collateral needs or be sold to reduce the funding requirement. An asset is therefore categorised as unencumbered if it has not been pledged against an existing liability. The group had an insignificant level of encumbrance at 31 December 2015 (2014: insignificant).

Additional contractual obligations
(Unaudited)

Under the terms of our current collateral obligations under derivative contracts (which are ISDA compliant CSA contracts), and based on the positions at 31 December 2015, we estimate that we could be required to post additional collateral of up to HK$448m (2014: HK$467m) in the event of a one-notch downgrade in credit ratings, which would increase to HK$541m (2014: HK$641m) in the event of a two-notch downgrade.

Forward-looking framework
(Unaudited)

From 1 January 2016, the Group will implement a new liquidity and funding risk management framework. Our new internal framework uses the Liquidity Coverage Ratio ('LCR') and Net Stable Funding Ratio ('NSFR') regulatory framework as a foundation, but adds additional metrics/limits and overlays to address the risks that the Group considers are not adequately reflected by the regulatory framework.

The key aspects of our new liquidity and funding risk management framework are:

- Standalone management of liquidity and funding by operating entity;
- Operating entity classification by ILR categorisation;
- Minimum operating entity LCR requirement dependent on ILR categorisation (EU LCR Delegated Regulation basis, being the implementation of the Basel III framework within Europe and therefore applicable to the HSBC Group);
- Minimum operating entity NSFR requirement dependent on ILR categorisation (Based on the final regulations published by the Basel Committee on Banking Supervision in October 2014, pending finalisation of the regulation within Europe that will be applicable to the HSBC Group);
- Legal entity depositor concentration limit;
- Operating entity three-month and twelve-month cumulative rolling term contractual maturity limits covering deposits from banks, deposits from non-bank financials and securities issued; and
- Annual Individual Liquidity Adequacy Assessment ('ILAA') by operating entity. The ILAA process has been designed to identify liquidity and funding risks that are not reflected in the liquidity and funding risk management framework and where additional limits may be assessed to be required locally, and to validate the Risk Tolerance at the operating entity level.

Our new liquidity and funding risk management framework and the risk tolerance (limits) were approved by the Risk Management Meeting of the GMB, and by the Board of Directors of HSBC Holding plc on the basis of the recommendation given by the Group Risk Committee.

The decision to create an internal framework based around the regulatory framework was driven by the need to ensure that the regulatory and our internal frameworks are directionally aligned and to ensure that the Group's internal funds transfer pricing framework incentivises the Global Business Lines within each operating entity to collectively ensure compliance with both the regulatory and our internal Risk Tolerance.

Liquidity regulation
(Unaudited)

The Banking (Liquidity) Rules were introduced by the HKMA in 2014 and became effective from 1 January 2015. Under rule 11(1), the group is required to calculate its LCR on a consolidated basis. During 2015 the group is required to maintain an LCR of not less than 60%, increasing in steps of 10% to not less than 100% by January 2019. The NSFR is expected to be implemented in Hong Kong from 1 January 2018.

The average LCRs for the period are as follows:

	Quarter Ended 31 December 2015	Quarter Ended 30 September 2015	Quarter Ended 30 June 2015	Quarter Ended 31 March 2015
	%	%	%	%
Average Liquidity Coverage Ratio	**159.8**	156.7	142.5	137.4

The liquidity position of the group remained strong in 2015. The average LCR increased by 22.4% from 137.4% for the quarter ended on 31 March 2015 to 159.8% for the quarter ended on 31 December 2015 as the growth in customer deposits exceeded the increase in loans and advances to customers, the surplus of which was deployed into high quality liquid assets ('HQLA').

Risk Report (continued)

The majority of HQLA included in the LCR are Level 1 assets as defined in the Banking (Liquidity) Rules, which consist mainly of government debt securities.

	Weighted amount (Average value)			
	Quarter Ended 31 December 2015 HK$m	Quarter Ended 30 September 2015 HK$m	Quarter Ended 30 June 2015 HK$m	Quarter Ended 31 March 2015 HK$m
Level 1 assets	**1,443,350**	1,405,245	1,368,320	1,324,230
Level 2A assets	**58,026**	49,916	41,658	35,956
Level 2B assets	**6,267**	7,729	7,992	7,314
Total weighted amount of HQLA	**1,507,643**	1,462,890	1,417,970	1,367,500

Further details of the group's liquidity information disclosures are set out in Appendix 3 'Liquidity Coverage Ratio Standard Disclosure Template' of the Supplementary Notes Appendices, which is available in the Regulatory Disclosure Section of our website: www.hsbc.com.hk .

Market Risk

(Audited)

Market risk is the risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.

There were no significant changes to our policies and practices for the management of market risk in 2015.

Exposure to market risk

Exposure to market risk is separated into two portfolios:

- *Trading portfolios* comprise positions arising from market-making and warehousing of customer-derived positions.
- *Non-trading portfolios* comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held to maturity, and exposures arising from our insurance operations.

The diagram below illustrates the main business areas where trading and non-trading market risks reside and market risk measures to monitor and limit exposures.

	Trading Risk	Non-Trading Risk			
Risk Types	- Foreign exchange & Commodities - Interest rates - Credit spreads - Equities	- Structural foreign exchange - Interest rates - Credit spreads			
Global Businesses	GB&M, incl BSM	GB&M, incl BSM	GPB	CMB	RBWM
Risk Measure	VaR / Sensitivity / Stress testing	VaR / Sensitivity / Stress testing			

Where appropriate, the group applies similar risk management policies and measurement techniques to both trading and non-trading portfolios. The group's objective is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the status as one of the world's largest banking and financial services organisations.

The nature of the hedging and risk mitigation strategies performed across the group corresponds to the market risk management instruments available within each operating jurisdiction. These strategies range from the use of traditional market instruments, such as interest rate swaps, to more sophisticated hedging strategies to address a combination of risk factors arising at portfolio level.

Market risk governance

(Audited)

Market risk is managed and controlled through limits approved by the Risk Management Meeting of the GMB for HSBC Holdings and the various global businesses. These limits are allocated across business lines and to the Group's legal entities. The management of market risk is principally undertaken in Global Markets through risk limits. Value at Risk ('VaR') limits are set for portfolios, products, and risk types, with market liquidity and business need being the primary factors in determining the level of limits set.

Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis. Each operating entity is required to assess the market risks arising on each product in its business and to transfer them to either its local Markets unit for management, or to separate books managed under the supervision of the local ALCO.

Our aim is to ensure that all market risks are consolidated within operations that have the necessary skills, tools, management and governance to manage them. In certain cases where the market risks cannot be fully transferred, we identify the impact of varying scenarios on valuations or on net interest income resulting from any residual risk positions.

Model risk is governed through Model Oversight Committees ('MOC's) at the regional and Global Wholesale Credit and Market Risk ('WCMR') level. They have direct oversight and approval responsibility for all traded risk models utilised for risk measurement and management and stress testing. The MOCs prioritise the development of models, methodologies and practices used for traded risk management and ensure that they remain within our risk appetite and business plans. The Markets MOC reports into the Group MOC, which oversees all risk types at Group level. Group MOC informs the Risk Management Meeting of the GMB about material issues at least on a bi-annual basis. The Risk Management Meeting is the Group's 'Designated Committee' according to the regulatory rules and it has delegated day-to-day governance of all traded risk models to the Global WCMR MOC.

Our control of market risk in the trading and non-trading portfolios is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by Group Risk, of enforcing new product approval procedures, and of restricting trading in the more complex derivative products only to sites with appropriate levels of product expertise and robust control systems.

Market risk measures

(Audited)

Monitoring and limiting market risk exposures

Our objective is to manage and control market risk exposures while maintaining a market profile consistent with our risk appetite. We use a range of tools to monitor and limit market risk exposures including sensitivity analysis, VaR and stress testing.

Sensitivity analysis

(Unaudited)

Sensitivity analysis measures the impact of individual market factor movements on specific instruments or portfolios including interest rates, foreign exchange rates and equity prices, for example, the impact of a one basis point change in yield. We use sensitivity measures to monitor the market risk positions within each risk type.

Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Value at risk

(Audited)

VaR is a technique that estimates the potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. The use of VaR is integrated into market risk management and is calculated for all trading positions regardless of how the group capitalises those exposures. Where there is no approved internal model, the group uses the appropriate local rules to capitalise exposures.

In addition, the group calculates VaR for non-trading portfolios in order to have a complete picture of market risk. Our models are predominantly based on historical simulation. VaR is calculated at a 99% confidence level for a one-day holding period. Where VaR is not calculated explicitly, alternative tools are used as summarised in the Market Risk Stress testing section below.

The VaR models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

The historical simulation models used incorporate the following features:

- historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- potential market movements utilised for VaR are calculated with reference to data from the past two years; and
- VaR measures are calculated to a 99 per cent confidence level and use a one-day holding period.

The nature of the VaR models means that an increase in observed market volatility will lead to an increase in VaR without any changes in the underlying positions.

VaR model limitations

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 holding period assumes that all positions can be liquidated or the risks offset during that period. This may not fully reflect the market risk arising at times of severe illiquidity, when the holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition does not take into account losses that might occur beyond this level of confidence;
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VaR is unlikely to reflect loss potential on exposures that only arise under significant market movements.

Backtesting

We routinely validate the accuracy of our VaR models by back-testing them against both actual, which replaced clean profit and loss from 1 August 2015, and hypothetical profit and loss against the trading VaR numbers. Hypothetical profit and loss excludes non-modelled items such as fees, commissions and revenues of intra-day transactions.

We would expect on average to see two to three profits, and two or three losses, in excess of VaR at the 99% confidence level over a one-year period. The actual number of profits or losses in excess of VaR over this period can therefore be used to gauge how well the models are performing. To ensure a conservative approach in calculating our risk exposures, it is important to note that profits in excess of VaR are only considered when back-testing the accuracy of models and are not used to calculate the VaR numbers used for risk management or capital purposes. VaR is back-tested at various levels which reflect the full scope of HSBC.

Risk not in VaR framework
(Unaudited)

Our VaR model is designed to capture significant basis risks such as credit default swaps versus bond, asset swap spreads and cross-currency basis. Other basis risks which are not completely covered in VaR, such as the Libor tenor basis, Libor-overnight index swap basis, dividend and correlation risks, are complemented by risk-not-in-VaR (‘RNIV’) calculations and are integrated into the capital framework.

The RNIV framework aims to manage and capitalise material market risks that are not adequately covered in the VaR model. An example of this is Libor-overnight index swap basis risk for minor currencies. In such instances, the RNIV framework uses stress tests to quantify the capital requirement. On average in 2015, the capital requirement derived from these stress tests represented 4.2% of the total internal model-based market risk requirement.

Risks covered by RNIV represent 10.2% of market risk RWAs for models with regulatory approval and include those resulting from underlying risk factors which are not observable on a daily basis across asset classes and products, such as dividend risk or do not have long enough data history for stressed VaR calculation.

Risk factors are reviewed on a regular basis and either incorporated directly in the VaR models, where possible, or quantified through the VaR-based RNIV approach or a stress test approach within the RNIV framework. The severity of the scenarios is calibrated to be in line with the capital adequacy requirements. The outcome of the VaR-based RNIV is included in the back-testing; a stressed VaR RNIV is also computed for the risk factors considered in the VaR-based RNIV approach.

Stress testing

(Audited)

Stress testing is an important tool that is integrated into our market risk management tool to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables. In such abnormal scenarios, losses can be much greater than those predicted by VaR modelling.

Stress testing is implemented at the legal entity, sites and the overall group levels. A standard set of scenarios is utilised consistently across all sites within the group. At a group level, a set of scenarios are defined to capture the relevant events or market movements at each level. The risk appetite around potential stress losses for the entity is set and monitored against referral limits.

The process is governed by the Stress Testing Review Group forum which, in conjunction with regional risk management, determines the scenarios to be applied at portfolio and consolidated level, as follows:

Market Risk Stress Testing				
Sensitivities	Technical	Hypothetical	Historical	Reverse Stress Testing
Impact of a single risk factor e.g. break of a currency peg	Impact of the largest move in each risk factor without consideration of any underlying market correlation	Impact of potential macroeconomic events, e.g. slowdown in mainland China	Scenarios that incorporate historical observations of market movements e.g. Black Monday (in 1987) for equities	

Market Risk Reverse stress tests are undertaken based upon the premise that there is a fixed loss. The stress test process identifies which scenarios lead to this loss. The rationale behind the reverse stress test is to understand scenarios which are beyond normal business settings that could have contagion and systemic implications.

Stressed VaR and stress testing, together with reverse stress testing and the management of gap risk, provide management with insights regarding the 'tail risk' beyond VaR for which our appetite is limited.

Gap risk

(Unaudited)

Certain products are structured in such a way that they give rise to enhanced gap risk, being the risk that loss is incurred upon occurrence of a gap event. A gap event is a significant and sudden change in market price with no accompanying trading opportunity. Such movements may occur, for example, when, in reaction to an adverse event or unexpected news announcement, some parts of the market move far beyond their normal volatility range and become temporarily illiquid. In 2015, gap risk principally arose from non-recourse loan transactions, mostly for corporate clients, where the collateral against the loan is limited to the posted shares. Upon occurrence of a gap event, the value of the equity collateral could fall below the outstanding loan amount.

Given their characteristics, these transactions make little or no contribution to VaR nor to traditional market risk sensitivity measures. We capture their risks within our stress testing scenarios and monitor gap risk on an ongoing basis. We did not incur any notable gap loss in 2015.

De-peg risk

(Unaudited)

For certain currencies (pegged or managed) the spot exchange rate is pegged at a fixed rate (typically to USD or EUR), or managed within a predefined band around a pegged rate. De-peg risk is the risk of the peg or managed band changing or being abolished, and moving to a floating regime.

The group has considerable experience in managing fixed and managed currency regimes. Using stressed scenarios on spot rates, we are able to analyse how de-peg events would impact the positions held by the group. We monitor such scenarios to pegged or managed currencies, such as the Hong Kong dollar, renminbi and Middle Eastern currencies, and limit any potential losses that would occur. This complements traditional market risk metrics, such as historical VaR, which may not fully capture the risk involved in holding positions in pegged or managed currencies. Historical VaR relies on past events to determine the likelihood of potential profits or losses. However, pegged or managed currencies may not have experienced a de-peg event during the historical timeframe being considered.

Volcker Rule

(Unaudited)

In 2013, US regulators finalised the Volcker Rule. Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and its final implementing rules (collectively referred to as the Volcker Rule) imposes broad restrictions on HSBC's ability to engage in proprietary trading or to own, sponsor, or have certain relationships with hedge funds, private equity funds, and certain other collective investment vehicles (broadly defined as covered funds). These restrictions are subject to a number of exemptions or exclusions, including market making, underwriting and risk-mitigating hedging, organising covered funds for customers and issuers of asset-backed securities, and underwriting or market making in covered fund interests.

The Volcker Rule broadly went into effect on 22 July 2015, with the exception of certain legacy fund activities that are able to rely on an extension of the conformance date.

HSBC has implemented a program to comply with the Volcker Rule, including policies and procedures, internal controls, corporate governance, independent testing, training, and recordkeeping and, eventually, calculation and reporting of quantitative metrics for certain trading activities.

HSBC has completed training for all affected front office and control personnel and believes that it is in compliance in all material respects with the Volcker Rule.

Market risk in 2015

(Unaudited)

Global markets experienced heightened volatilities since mid-2015, including ongoing concerns about mainland China's economic slowdown, RMB FX fixing risk, expectation of rising US interest rate, together with a number of unexpected monetary policy developments and geo-political events. In light of this global market backdrop and the objective of more efficient management of capital, the group has reduced the size of the trading positions, as reflected in the key market risk measures whereby Trading VaR is trending downwards.

Trading portfolios
(Audited)

Value at risk of the trading portfolios

Trading VaR predominantly resides within Global Markets. For 2015, overall trading VaR decreased by 53% from HK$190m to HK$89m. This is mainly driven by Interest Rate VaR due to more efficient management of RWAs and reduced warehoused positions.

The trading VaR for the year is shown in the table below.

Trading value at risk, 99% 1 day[1]
(Audited)

	Foreign exchange and commodity HK$m	Interest rate HK$m	Equity HK$m	Credit spread HK$m	Portfolio diversification[2] HK$m	Total HK$m
At 31 December 2015						
Year end	**31**	**70**	**21**	**29**	**(62)**	**89**
Average	**54**	**102**	**16**	**27**		**134**
Maximum	**92**	**194**	**39**	**45**		**238**
At 31 December 2014						
Year end	37	151	28	27	(55)	190
Average	43	124	18	23		138
Maximum	72	174	34	40		199

1 *Trading portfolios comprise positions arising from the market-making and warehousing of customer-derived positions.*

2 *Portfolio diversification is the market risk dispersion effect of holding a portfolio containing different risk types. It represents the reduction in unsystematic market risk that occurs when combining a number of different risk types, for example, interest rate, equity and foreign exchange, together in one portfolio. It is measured as the difference between the sum of the VaR by individual risk type and the combined total VaR. A negative number represents the benefit of portfolio diversification. As the maximum and minimum occur on different days for different risk types, it is not meaningful to calculate a portfolio diversification benefit for these measures.*

Non-trading portfolios
(Unaudited)

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 embedded optionality within certain investment product areas, such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts, and the re-pricing behaviour of managed rate products.

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 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.

Sensitivity of net interest income

A principal part of our management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling).

The group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream. 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.

Structural foreign exchange exposures
(Unaudited)

Structural foreign exchange exposures, monitored using sensitivity analysis, represent net investments in subsidiaries, branches and associates, the functional currencies of which are currencies other than the HK dollar. An entity's functional currency is that of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recognised in 'Other comprehensive income'.

We hedge structural foreign exchange exposures only in limited circumstances. Our structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that our consolidated capital ratios and the capital ratios of individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

We may also transact hedges where a currency in which we have structural exposures is considered likely to revalue adversely, and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under HKFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved.

The group had the following structural foreign currency exposures that were not less than 10% of the total net structural foreign currency positions:

	LCYm	HK$m equivalent
At 31 December 2015		
Renminbi	**156,567**	**186,866**
At 31 December 2014		
Renminbi	158,785	198,584

Operational Risk

(Audited)

Operational risk is the risk to achieving our strategy or objectives as a result of inadequate or failed internal processes, people and systems or from external events. Operational risk is relevant to every aspect of our business and covers a wide spectrum of issues, in particular legal, compliance, security and fraud. Losses arising from breaches of regulation and law, unauthorised activities, error, omission, inefficiency, fraud, systems failure or external events all fall within the definition of operational risk.

Responsibility for minimising operational risk lies with management and staff. Every employee plays a role in managing operational risk. Accountability for managing and controlling risks lies directly with individual risk and control owners in the business.

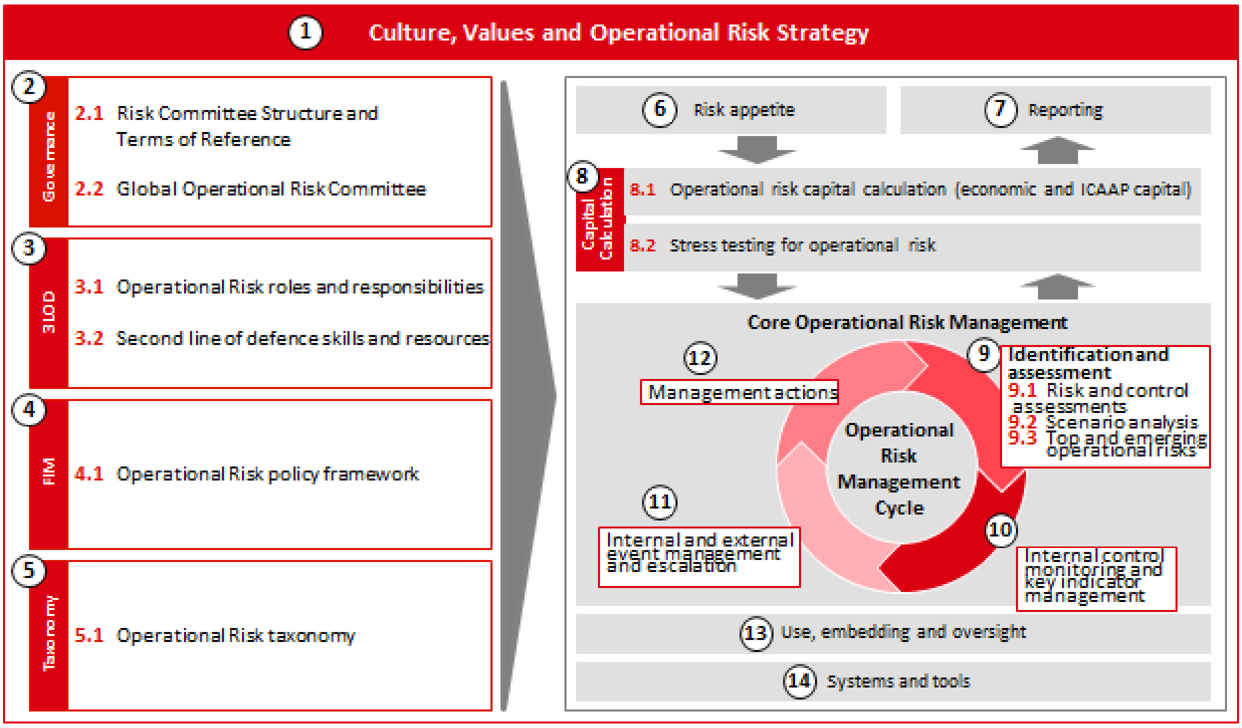
Operational risk management framework

HSBC's Operational Risk Management Framework ('ORMF') is our overarching approach for managing operational risk in accordance with our business and operational risk strategies. The purpose of the ORMF is to make sure we fully identify and manage our operational risks in an effective manner and maintain our targeted levels of operational risk within risk appetite, as defined by the Board.

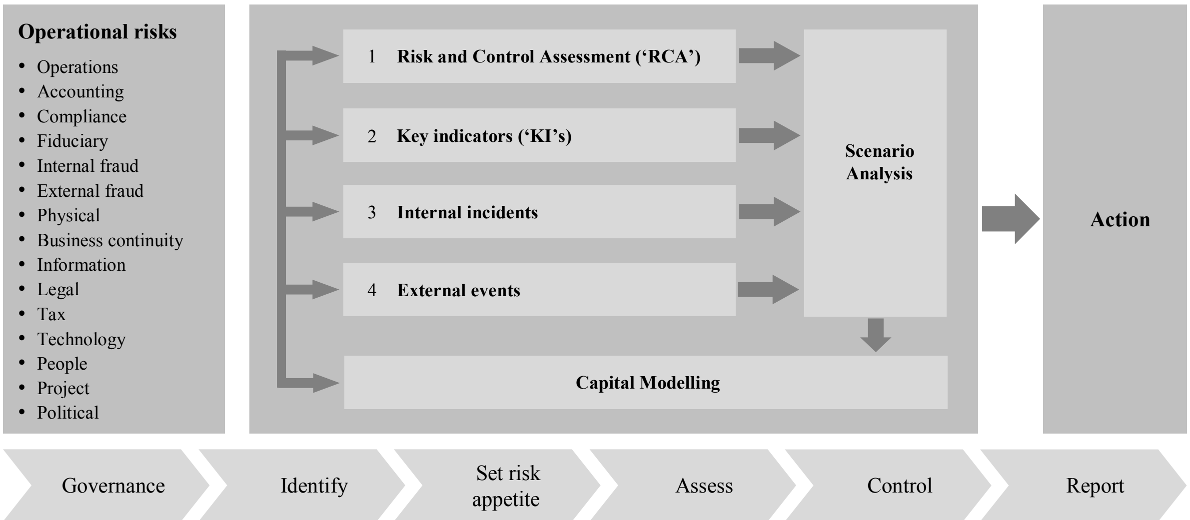
Articulating our risk appetite for material operational risks helps the organisation understand the level of risk it is willing to accept. Our operational risk appetite is approved annually by the Risk Management Committee. Monitoring operational risk exposure against risk appetite on a regular basis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

Activities to strengthen our operational risk culture and to better embed the use of our ORMF continued in 2015. In particular, we continued to streamline our operational risk management processes, procedures and tool sets to provide more forward-looking risk insights and more effective operation of the ORMF. The ORMF comprises the 14 key components set below.

Key Components of the Operational Risk Management Framework



Risk Report (continued)



Three lines of defence

We use the three lines of defence model to underpin our approach to strong risk management. It is activity-based and defines who is responsible to do what to identify, assess, measure, manage, monitor, and mitigate operational risks, encouraging collaboration and enabling efficient coordination of risk and control activities.

- The first line of defence is accountable for managing and monitoring operational risk in the business.
- The second line is responsible for providing risk oversight, challenge, advice and insights to the business.
- The third line of defence independently assures that the Bank is managing operational risk effectively.

Key operational risks (Unaudited)

- *Compliance with regulatory requirements:* Our ability to respond to increasing demands or changes in regulatory requirements in the markets in which we operate remains a critical focus. Failure to implement our obligations under the US DPA, for instance, could have a material adverse effect on our results and operations. A Global Standards programme is being rolled out to ensure implementation of critical regulatory and financial crime compliance requirements. Various conduct and values initiatives have also been initiated to ensure that exposures to mis-selling or market conduct abuses are minimised.

- *Level of change creating operational complexity:* operational stresses may occur during periods of growth as well as during volatile periods in a market downturn. The Operational Risk function engages with business management in business transformation initiatives to ensure the resilience of the internal control environment. This may involve thematic reviews of new initiatives and analysis of loss or indicator trends, as well as participation and discussion of issues or concerns at relevant governance or management committees.

- *Fraud and financial crime*: the threat of fraud perpetrated by or against our customers, especially in retail and commercial banking, may increase during adverse economic conditions. We have increased monitoring, root cause analysis and review of internal controls to enhance our defences against external attacks and reduce the level of loss in these areas. In addition, Group Security and Fraud Risk work closely with global businesses to continually assess these threats as they evolve and adapt our controls to mitigate them. We may also be exposed to potential criminal activities and have invested heavily in improving its customer due diligence and transaction monitoring and screening controls.

- *Information security*: the security of our information and technology infrastructure is crucial for maintaining our banking applications and processes while protecting our customers and our franchise. A failure of our defences against such attacks could result in financial loss, loss of customer data and other sensitive information which could undermine both our reputation and our ability to retain the trust of our customers.

- *Third party risks:* procedures are in place to conduct due diligence and monitor the performance of third party suppliers and service providers in so far as they may affect our ability to service our customers.

- *People risk*: attracting and retaining staff with appropriate skills and expertise across the markets in which we operate remains a challenge. Significant investment is made in training and management development initiatives to equip our staff for the business changes we face and for the implementation of global standards.

Compliance risk

Compliance risk arises from activities subject to rules, regulations, Group policies and other formal standards, including those relating to anti-money laundering ('AML'), counter-terrorist and proliferation financing, sanctions compliance, anti-bribery and corruption, conduct of business and other regulations.

US Deferred Prosecution Agreement (DPA) and related agreements and consent orders

An independent compliance monitor ('the Monitor') was appointed in 2013 under the 2012 agreements entered into with the US Department of Justice ('DoJ') and the UK Financial Conduct Authority ('FCA') to produce annual assessments of the effectiveness of our AML and sanctions compliance programme. Additionally, the Monitor is serving as HSBC's independent consultant under the consent order of the US Federal Reserve Board. In January 2016, the Monitor delivered his second annual follow-up review report as required by the US DPA. Under the terms of the US DPA, upon notice and an opportunity to be heard, the DoJ has sole discretion to determine whether HSBC has breached the US DPA. Potential consequences of breaching the US DPA could include the imposition of additional terms and conditions on HSBC, an extension of the agreement, including its monitorship, or the criminal prosecution of HSBC, which could, in turn, entail further financial penalties and collateral consequences.

Breach of the US DPA or related agreements and consent orders could have a material adverse effect on our business, financial condition and results of operations, including loss of business and withdrawal of funding, restrictions on performing dollar-clearing functions through HSBC Bank USA or revocation of bank licences. Even if it is determined that we have not breached these agreements, but the agreements are amended or their terms extended, our business, reputation and brand could suffer materially.

Mitigating actions

We are continuing to take concerted action to remedy AML and sanctions compliance deficiencies and to implement Global Standards. We are also working to implement the agreed recommendations flowing from the Monitor's 2013 and 2014 reviews, and will implement the agreed recommendations from the 2015 review.

During 2015, we continued to make progress towards putting in place a robust and sustainable AML and sanctions compliance programme, including continuing to build a strong Compliance function, rolling out improved systems and infrastructure to manage financial crime risk, improve transaction monitoring and enhancing internal audit.

Anti-money laundering and sanctions

Revised global AML and sanctions policies were approved in 2014. During 2015, global businesses and countries introduced new AML and sanctions procedures arising from the new policies and focused on embedding the procedures required to effect these policies in our day to day business operations globally. This supported our ongoing effort to address the US DPA requirements. These actions were in line with our strategic target to complete the implementation of Global Standards by the end of 2017.

Anti-bribery and corruption

It is unethical, illegal, and contrary to good corporate governance to bribe or corrupt others. The Group is committed to preventing bribery and corruption, and to consistently applying the letter and spirit of applicable anti-bribery legislation in all markets and jurisdictions in which we operate. We have implemented a strategic programme to address bribery and corruption risks and are embedding a new global suite of policies that make it clear to all staff that Group members, employees or other associated persons or entities must not engage in, or otherwise facilitate, any form of bribery, whether direct or indirect.

The anti-bribery and corruption programme, from training to risk assessment, emphasises the importance of consistent and standardised procedures to drive the principles of 'detect, deter and protect' and ensure that they are incorporated into every aspect of business-as-usual activities.

Reputational Risk

(Unaudited)

Reputational risk is the failure to meet stakeholder expectations as a result of any event, behaviour, action or inaction, either by HSBC itself, our employees or those with whom we are associated, that might cause stakeholders to form a negative view of HSBC.

Reputational risk relates to perceptions, whether based on fact or otherwise. Stakeholders' expectations are constantly changing and thus reputational risk is dynamic and varies between geographies, groups and individuals. As a global bank, we show unwavering commitment to operating, and to be seen to be operating, to the high standards we have set for ourselves in every jurisdiction. Reputational risk might result in financial or non-financial impacts, loss of confidence, adverse effects on our ability to keep and attract customers, or other consequences. Any lapse in standards of integrity, compliance, customer service or operating efficiency represents a potential reputational risk.

A number of measures to enhance our anti-money laundering, sanctions and other regulatory compliance frameworks have been taken and/or are ongoing. These measures, which should also serve over time to enhance our reputational risk management, include the following:

- simplifying our business through the progressive implementation of our Group strategy, including the adoption of a global financial crime risk filter, which should help to standardise our approach to doing business in higher risk countries;
- an increase in reputational risk resources in each region in which we operate, and the introduction of a central case management and tracking process for reputational risk and client relationship matters;
- the creation of combined reputational risk and client selection committees within the global businesses, with a clear process to escalate and address matters at the appropriate level;
- the continued roll-out of training and communication about the HSBC Values Programme that defines the way everyone in the Group should act, and seeks to ensure that the Values are embedded into our operations; and
- the continuous development and implementation of the Global Standards around financial crime compliance, which underpin our businesses. This includes ensuring globally consistent application of policies that govern AML and sanctions compliance provisions.

HSBC has zero tolerance for knowingly engaging in any business, activity or association where foreseeable reputational damage has not been considered and mitigated. There must be no barriers to open discussion and escalation of issues that could affect the Group negatively. While there is a level of risk in every aspect of business activity, appropriate consideration of potential harm to HSBC's good name must be a part of all business decisions. Detecting and preventing illicit actors' access to the global financial system calls for constant vigilance and we will continue to cooperate closely with all governments to achieve success. This is integral to the execution of our strategy, to HSBC Values and to preserving and enhancing our reputation.

Risks of insurance manufacturing operations

(Audited)

The majority of the risk in the insurance business derives from manufacturing activities and can be categorised as insurance risk and financial risk. Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the insurer. The principal insurance risk faced by the group is that, over time, the combined cost of claims, benefits, administration and acquisition of the contracts may exceed the aggregate amount of premiums received and investment income. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has discretionary participation features or guaranteed cash benefit, the performance of the assets held to support the liabilities. The severity of the claims and benefits, as well as the timing, is therefore uncertain. Contracts under which the transfer of insurance risk from the policyholder to the group is not significant are classified as investment contracts. Financial risks include market risk, credit risk and liquidity risk.

The group measures the risk profile of the insurance manufacturing businesses using an economic capital model, where assets and liabilities are measured on a market value basis and a capital requirement is held to ensure that there is less than a 1-in-200 chance of insolvency over the next year, given the risks that the businesses are exposed to. The methodology for the economic capital calculation is largely aligned to the new pan European Solvency II insurance capital regulations, which are applicable from 2016.

The group manages its insurance risk through asset and liability management, underwriting limits, approval procedures for transactions that involve new products or that exceed set limits, risk diversification, pricing guidelines, reinsurance and monitoring of emerging issues, taking into account where appropriate local market conditions and any regulatory requirements that apply.

All insurance products, whether internally manufactured or provided by a third party manufacturer, are reviewed by the Product Committee. Several methods are used to assess and monitor insurance risk exposures for both individual types of risks insured and overall risks. These methods include internal risk measurement models, sensitivity analyses, scenario analyses and stress testing.

The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. Insurance events are, by their nature, incorporated with a certain degree of randomness and the actual number of events during any one year may vary from those estimated using established statistical techniques.

Asset and liability management (insurance)

A principal tool used by the group to manage the exposures to both financial and insurance risk is asset and liability matching. The group manages its assets using an approach that considers asset quality, diversification, cash flow matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return within acceptable parameters. The Investment Committee reviews and approves strategic asset allocation on a periodic basis and establishes investment guidelines. The asset and liability management process is also overseen by the Asset and Liability Management Committee of the group's insurance business.

The group establishes asset portfolios for each major insurance product category consistent with local regulatory requirements. The investment policy defines the asset allocation and restrictions with the aim of achieving the target investment return in the long term.

The following table shows the composition of assets and liabilities by type of contract. 93% of both assets and liabilities are derived from Hong Kong.

Balance sheet of insurance manufacturing subsidiaries by type of contract

	Non-linked contracts[1] HK$m	Linked contracts[2] HK$m	Other assets and liabilities[3] HK$m	Total HK$m
At 31 December 2015				
Financial assets:				
– financial assets designated at fair value	51,197	46,561	426	98,184
– derivatives	633	1	86	720
– financial investments- held-to-maturity	204,961	–	23,638	228,599
– financial investments- available-for-sale	41,583	–	1,066	42,649
– other financial assets	23,796	1,444	3,525	28,765
Total financial assets	322,170	48,006	28,741	398,917
Reinsurance assets	7,303	1,402	–	8,705
PVIF[4]	–	–	36,897	36,897
Other assets	7,275	6	3,232	10,513
Total assets	336,748	49,414	68,870	455,032
Liabilities under investment contracts designated at fair value	29,228	6,821	–	36,049
Liabilities under insurance contracts	298,576	42,244	–	340,820
Deferred tax	95	–	5,846	5,941
Other liabilities	–	–	10,445	10,445
Total liabilities	327,899	49,065	16,291	393,255
Total equity	–	–	61,777	61,777
Total equity and liabilities	327,899	49,065	78,068	455,032

Risk Report (continued)

	Non-linked contracts[1] HK$m	Linked contracts[2] HK$m	Other assets and liabilities[3] HK$m	Total HK$m
At 31 December 2014				
Financial assets:				
– financial assets designated at fair value	47,048	49,343	546	96,937
– derivatives	173	3	24	200
– financial investments- HTM	163,289	–	19,336	182,625
– financial investments- AFS	49,128	–	1,017	50,145
– other financial assets	35,891	1,433	821	38,145
Total financial assets	295,529	50,779	21,744	368,052
Reinsurance assets	4,341	1,454	–	5,795
PVIF[4]	–	–	32,389	32,389
Other assets	6,053	5	2,695	8,753
Total assets	305,923	52,238	56,828	414,989
Liabilities under investment contracts designated at fair value	29,239	7,426	–	36,665
Liabilities under insurance contracts	265,743	44,439	–	310,182
Deferred tax	225	–	6,021	6,246
Other liabilities	–	–	3,571	3,571
Total liabilities	295,207	51,865	9,592	356,664
Total equity	–	–	58,325	58,325
Total equity and liabilities	295,207	51,865	67,917	414,989

1 *Comprises life non-linked insurance contracts, non-linked investment contracts and remaining non-life insurance contracts.*
2 *Comprises life linked insurance contracts and linked investment contracts.*
3 *Comprises shareholder assets and liabilities.*
4 *Present value of in-force long-term insurance business.*

Underwriting strategy

The group's underwriting strategy seeks to achieve a balanced portfolio and is based on a large portfolio of similar risks over a number of years and, as such, it is believed that this reduces the variability of the outcomes.

Reinsurance strategy

The group limits the exposure to large claims and catastrophe claims by transferring excessive risks to reinsurance companies with high credit quality. Retention limits are set depending on the nature of risks and type of benefits. The group also uses reinsurance to manage financial risk arising from certain products that it has sold. Although reinsurance provides a means of managing risks, it exposes the group to credit risk arising from default by the reinsurers. Management of such credit risk exposure is described on page 66.

Nature of risks covered

Life business is generally long term in nature and frequently involves an element of savings and investment in the contract. The following gives an assessment of the nature of risks inherent in the group's main manufactured 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, credit rating 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 or terminal 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. Charges for the cost of insurance and administration are deducted from the funds accumulated. There is a unit-linked product with significant performance guarantee where 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 to invest their contributions. 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.

Insurance risk is principally measured in terms of liabilities under the contracts in force. Details of the analysis of life insurance liabilities are disclosed in note 31. Since the group is not exposed to significant insurance risk on investment contracts, they have not been included in the insurance risk management analysis.

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 number of related small contracts, and relate to circumstances where a large claim from a single or multiple contracts 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 of the policyholders insured by the group. To mitigate some of these risks, catastrophe reinsurance arrangements have been made by the group, where appropriate. Details of the group's reinsurance strategy are disclosed on page 62.

The policyholders of the insurance contracts issued by the group and its joint venture are mainly residents of Hong Kong, Macau, mainland China, Singapore, Malaysia and India, with the majority in Hong Kong.

To determine the concentration of insurance risks and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the group. Total loss is estimated based on the chosen stress level.

Financial risks (insurance)

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. 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, a provision is established to provide additional coverage.

The following table analyses the assets held in the group's insurance manufacturing subsidiaries at 31 December 2015 by type of contract, and provides a view of the exposure to financial risk. For linked contracts, which pay benefits to policyholders determined by reference to the value of the investments supporting the policies, 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.

Risk Report (continued)

Financial assets held by insurance manufacturing subsidiaries

At 31 December 2015	Non-linked contracts HK$m	Linked contracts HK$m	Other assets HK$m	Total HK$m
Financial assets designated at fair value				
– Debt securities	**17,399**	**89**	**426**	**17,914**
– Equity securities	**33,798**	**46,472**	**–**	**80,270**
	51,197	**46,561**	**426**	**98,184**
Financial investments				
Held-to-maturity:				
– Debt securities	**204,961**	**–**	**23,638**	**228,599**
Available-for-sale:				
– Debt securities	**41,582**	**–**	**634**	**42,216**
– Equity securities	**1**	**–**	**432**	**433**
	41,583	**–**	**1,066**	**42,649**
Derivatives	**633**	**1**	**86**	**720**
Other financial assets	**23,796**	**1,444**	**3,525**	**28,765**
	322,170	**48,006**	**28,741**	**398,917**

At 31 December 2014	Non-linked contracts HK$m	Linked contracts HK$m	Other assets HK$m	Total HK$m
Financial assets designated at fair value				
– Debt securities	15,424	11	546	15,981
– Equity securities	31,624	49,332	–	80,956
	47,048	49,343	546	96,937
Financial investments				
Held-to-maturity:				
– Debt securities	163,289	–	19,336	182,625
Available-for-sale:				
– Debt securities	49,127	–	793	49,920
– Equity securities	1	–	224	225
	49,128	–	1,017	50,145
Derivatives	173	3	24	200
Other financial assets	35,891	1,433	821	38,145
	295,529	50,779	21,744	368,052

Approximately 73% (2014: 68%) of financial assets were invested in debt securities at 31 December 2015, with 21% (2014: 22%) invested in equity securities.

Under linked contracts, premium income less charges levied is invested in a portfolio of assets. The group manages the financial risks of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. These assets represented 12% (2014: 14%) of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2015.

The remaining financial risks are managed either solely on behalf of the shareholder, or jointly on behalf of the shareholder and policyholders where the discretionary participation mechanism exists.

Market risk (insurance)

Market risk can be sub-categorised into interest rate risk, equity and other price risks and foreign currency risk. Each of these categories is discussed further below. For participating products, market risk can be shared with policyholders under the discretionary participation mechanism.

Interest rate risk

The exposure of the 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.

The following table illustrates the effects of selected interest rate scenarios on our profit for the year and total equity of our insurance subsidiaries:

	31 December 2015		31 December 2014	
	Impact on profit after tax for the year HK$m	**Impact on net assets HK$m**	Impact on profit after tax for the year HK$m	Impact on net assets HK$m
+ 100 basis points parallel shift in yield curves	**172**	**(3,602)**	1,463	(3,221)
– 100 basis points parallel shift in yield curves	**(949)**	**3,618**	(1,720)	3,973

The interest rate sensitivities set out above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. The sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products but do not incorporate other actions that could be taken by management to mitigate the impact of the effect of the interest rate movements, nor do they take account of any resultant changes in policyholder behaviour.

Equity and other price risks

The portfolio of securities, including equities and other assets, which the group carries on the balance sheet at fair value, has exposure to price, yield and volatility risks. The price risk is defined as the potential loss in market value resulting from an adverse change in prices. The risk is mitigated, to an extent, through dynamic asset allocation and portfolio diversification. Portfolio characteristics are analysed regularly and these risks are regularly reviewed. The group's investment portfolios are diversified across industries and asset classes, with concentrations in any one company, industry or asset class limited by parameters established by senior management, as well as by statutory requirements.

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

	31 December 2015		31 December 2014	
	Impact on profit after tax for the year HK$m	**Impact on net assets HK$m**	Impact on profit after tax for the year HK$m	Impact on net assets HK$m
10% increase in equity prices	**1,225**	**1,225**	1,173	1,173
10% decrease in equity prices	**(1,092)**	**(1,092)**	(938)	(938)

These equity sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products but do not allow for the effect of other management actions which may mitigate the impact of the equity price decline, nor for any resultant changes in policyholder behaviour that might accompany such a fall.

Foreign currency risk

A significant proportion of the assets and liabilities are denominated in two main currencies, Hong Kong dollars and United States dollars. The group adopts a policy of predominantly matching the liabilities with assets 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 also uses forward exchange contracts and swaps to manage its foreign currency risk.

The following table illustrates the impact on the profit for the year and net assets of a 10% variance in USD exchange rate compared to all currencies:

	31 December 2015		31 December 2014	
	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 USD exchange rate compared to all currencies	**136**	**136**	398	398
10% decrease in USD exchange rate compared to all currencies	**(136)**	**(136)**	(398)	(398)

The foreign currency sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products but do not allow for the effect of other management actions which may mitigate the impact of the foreign currency movements, nor for any resultant changes in policyholder behaviour.

Credit risk (insurance)

The insurance operation's portfolios of fixed income securities, and to a lesser extent short-term and other investments, are subject to credit risk. This risk is defined as the potential financial loss resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive 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. Only assets supporting non-linked liabilities are included in the table, as financial risk on assets supporting linked liabilities is predominantly borne by the policyholders. 88% (2014: 89%) of the assets included in the table are invested in investments rated as 'Strong'. There were no investments rated as sub-standard or below.

	At 31 December 2015				At 31 December 2014			
	Neither past due nor impaired				Neither past due nor impaired			
	Strong	**Good**	**Satisfactory**	**Total**	Strong	Good	Satisfactory	Total
	HK$m	**HK$m**	**HK$m**	**HK$m**	HK$m	HK$m	HK$m	HK$m
Supporting liabilities under non-linked insurance and investment contracts								
Financial assets designated at fair value	**15,739**	**635**	**1,025**	**17,399**	14,123	407	894	15,424
– treasury and other eligible bills	**1,008**	**–**	**–**	**1,008**	–	–	–	–
– debt securities	**14,731**	**635**	**1,025**	**16,391**	14,123	407	894	15,424
Financial investments	**217,729**	**16,900**	**11,914**	**246,543**	187,906	14,181	10,329	212,416
– debt securities	**217,729**	**16,900**	**11,914**	**246,543**	187,906	14,181	10,329	212,416
Supporting shareholders funds[1]								
Financial assets designated at fair value	**380**	**–**	**46**	**426**	499	13	34	546
– treasury and other eligible bills	**62**	**–**	**–**	**62**	–	–	–	–
– debt securities	**318**	**–**	**46**	**364**	499	13	34	546
Financial investments	**22,629**	**321**	**1,322**	**24,272**	18,718	347	1,064	20,129
– debt securities	**22,629**	**321**	**1,322**	**24,272**	18,718	347	1,064	20,129
Total								
Financial assets designated at fair value	**16,119**	**635**	**1,071**	**17,825**	14,622	420	928	15,970
– treasury and other eligible bills	**1,070**	**–**	**–**	**1,070**	–	–	–	–
– debt securities	**15,049**	**635**	**1,071**	**16,755**	14,622	420	928	15,970
Financial investments	**240,358**	**17,221**	**13,236**	**270,815**	206,624	14,528	11,393	232,545
– debt securities	**240,358**	**17,221**	**13,236**	**270,815**	206,624	14,528	11,393	232,545

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 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:

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong	**Good**	**Satisfactory**	**Sub-standard**	**Past due not impaired**	**Impaired**	**Total**
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2015							
Non-linked insurance contracts	**7,100**	**–**	**51**	**–**	**–**	**–**	**7,151**
Linked insurance contracts	**4**	**1,388**	**–**	**–**	**–**	**–**	**1,392**
Total	**7,104**	**1,388**	**51**	**–**	**–**	**–**	**8,543**
Reinsurance debtors	**67**	**21**	**–**	**–**	**73**	**–**	**161**
At 31 December 2014							
Non-linked insurance contracts	4,128	1	53	–	–	–	4,182
Linked insurance contracts	3	1,438	–	–	–	–	1,441
Total	4,131	1,439	53	–	–	–	5,623
Reinsurance debtors	28	35	–	–	109	–	172

Liquidity risk (insurance)

There are three components of liquidity risk. The first of these arises in normal market conditions and is referred to as funding liquidity risk, specifically, the capacity to raise sufficient cash when needed to meet payment obligations. Secondly, there is market liquidity risk where the size of a particular holding may be sufficiently large that a sale cannot be completed at or around the market price. Finally, there is standby liquidity risk which refers to the capacity to meet payment conditions in abnormal conditions.

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

The following table shows the expected maturity of insurance contract liabilities at 31 December 2015:

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 2015					
Non-linked insurance contracts...	**26,738**	**112,308**	**230,750**	**237,112**	**606,908**
Linked insurance contracts..........	**2,454**	**13,397**	**42,131**	**82,993**	**140,975**
	29,192	**125,705**	**272,881**	**320,105**	**747,883**
At 31 December 2014					
Non-linked insurance contracts...	24,109	91,832	223,103	242,465	581,509
Linked insurance contracts..........	2,479	11,095	51,560	100,679	165,813
	26,588	102,927	274,663	343,144	747,322

Remaining contractual maturity of investment contract liabilities

	Non-linked investment contracts HK$m	Linked investment contracts HK$m	Total HK$m
At 31 December 2015			
Remaining contractual maturity			
– due within 1 year	**187**	**162**	**349**
– due between 1 and 5 years	**–**	**–**	**–**
– due between 5 and 10 years	**–**	**–**	**–**
– undated[1]	**29,041**	**6,659**	**35,700**
	29,228	**6,821**	**36,049**
At 31 December 2014			
Remaining contractual maturity			
– due within 1 year	34	156	190
– due between 1 and 5 years	–	–	–
– due between 5 and 10 years	–	–	–
– undated[1]	29,205	7,270	36,475
	29,239	7,426	36,665

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.*

Present value of in-force long-term insurance business ('PVIF')

The life insurance business is accounted for using the embedded value approach, which, inter alia, provides a framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2015 was HK$36,897m (2014: HK$32,389m), representing the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

The valuation of the PVIF asset includes explicit risk margins for non-economic risks in the projection assumptions and explicit allowances for financial options and guarantees using stochastic methods. Both the risk discount rate and investment return assumptions are set on active basis with reference to market risk free yields.

PVIF is 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 2015 of changes in the main economic assumption:

	Impact on PVIF	
	2015	2014
	HK$m	HK$m
+ 100 basis points shift in risk-free rate	**(63)**	1,357
– 100 basis points shift in risk-free rate	**(64)**	(813)

The effects on PVIF shown above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products but do not incorporate other actions that could be taken by management to mitigate effects, nor do they take account of consequential changes in policyholder behaviour.

Non-economic assumptions

Non-economic assumptions, including, mortality and/or morbidity, lapse rates and expense rates, are also used for the determination of the policyholders' liabilities and PVIF, subject to any relevant local regulatory requirements. The process used to determine the non-economic assumptions is intended to result in stable and prudent estimates of future outcomes. This is achieved by incorporating risk margins into best estimate 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. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2015 across all insurance manufacturing subsidiaries is as follows:

	Impact on 2015 results		Impact on 2014 results	
	Profit after tax	**Net assets**	Profit after tax	Net assets
	HK$m	**HK$m**	HK$m	HK$m
10% increase in mortality and/or morbidity rates	**(402)**	**(402)**	(294)	(294)
10% decrease in mortality and/or morbidity rates	**400**	**400**	301	301
10% increase in lapse rates	**(355)**	**(355)**	(319)	(319)
10% decrease in lapse rates	**407**	**407**	370	370
10% increase in expense rates	**(285)**	**(285)**	(303)	(303)
10% decrease in expense rates	**271**	**271**	299	299

The effects on profit after tax and net assets shown above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established risk sharing mechanism with policyholders for participating products, but do not incorporate other actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

Capital

Capital Management

(Audited)

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.

The policy on capital management is underpinned by a capital management framework, which enables us to manage our capital in a consistent manner. The framework defines the regulatory capital and economic capital measures as the two primary measures for the management and control of capital.

Capital measures:

- economic capital is the internally calculated capital requirement to support risks to which we are exposed and forms a core part of the internal capital adequacy assessment; and
- regulatory capital is the capital which we are required to hold in accordance with the rules established by regulators.

Our capital management process is articulated in our annual capital plan which is approved by the Board. The plan is drawn up with the objective of maintaining both an appropriate amount of capital and an optimal mix between the different components of capital. Each subsidiary manages its own capital to support its planned business growth and meet its local regulatory requirements within the context of the approved annual group capital plan. In accordance with the 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 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, other equity instruments, retained profits, other reserves, preference shares and subordinated liabilities.

Externally imposed capital requirements
(Audited)

The Hong Kong Monetary Authority ('HKMA') supervises the group on both a consolidated and solo-consolidated basis and therefore receives information on the capital adequacy of, and sets capital requirements for, the group as a whole and on a solo-consolidated basis. 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 and the internal ratings-based (securitisation) approach to determine credit risk for its banking book securitisation exposures. For market risk, the group uses an internal models approach to calculate its general market risk for the risk categories of interest rate exposures, foreign exchange (including gold) exposures, and equity exposures. The group also uses an internal models approach to calculate its market risk in respect of specific risk for interest rate exposures and equity exposures. The group uses the standardised (market risk) approach for calculating other market risk positions as well as trading book securitisation exposures, and the standardised (operational risk) approach to calculate its operational risk.

During the year, the individual entities within the group and the group itself complied with all of the externally imposed capital requirements of the HKMA.

Basel III
(Unaudited)

Since December 2010, the Basel Committee has developed a comprehensive set of reform measures covering additional capital, leverage and liquidity requirements, commonly referred to as 'Basel III'.

The Basel III capital rules set out the minimum common equity tier 1 (CET1) requirement of 4.5% and a minimum total capital requirement of 8% from 1 January 2015.

In addition to the criteria detailed in the Basel III proposals, the Basel Committee issued further minimum requirements in January 2011 to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The capital treatment of securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

The provisions of the Banking (Capital) (Amendment) Rules 2012 came into effect on 1 January 2013 to implement the first phase of the Basel III capital standards in Hong Kong ('Basel III rules').

The Banking (Capital) (Amendment) Rules 2014 came into effect on 1 January 2015 to implement the Basel III capital buffer requirements in Hong Kong. The changes include the phase-in from 2016 to 2019 of the Capital Conservation Buffer ('CCB') which is designed to ensure banks build up capital outside periods of stress of 2.5% of RWAs, the Countercyclical Capital Buffer ('CCyB') which is set on an individual country basis and is built up during periods of excess credit growth to protect against future losses, and the Higher Loss Absorbency ('HLA') requirement for Domestic Systemically Important Banks ('D-SIB') of up to 3.5 % of RWAs. The CCyB for Hong Kong is 0.625% from 1 January 2016 and the HKMA announced on 14 January 2016 that it will be increased to 1.25% from 1 January 2017. This increase is consistent with the Basel III phase-in arrangements for the CCyB. On 16 March 2015, the HKMA announced the designation of the group as a D-SIB and the HLA requirement to be 2.5% of RWAs which will be phased-in from 0.625% in 2016 to reach the full implementation in 2019. On 31 December 2015, the HKMA confirmed the designation of the group as a D-SIB as well as the HLA requirements.

Total Loss Absorbing Capacity proposals
(Unaudited)

In November 2014, as part of the 'too big to fail' agenda, the Financial Stability Board ('FSB') published proposals for Total Loss-absorbing Capacity ('TLAC') for Global Systemically Important Banks ('G-SIBs'). In November 2015, the FSB issued its final term sheet on TLAC which set the minimum TLAC requirement to be 16% of RWAs from 1 January 2019, rising to 18% from 1 January 2022. In addition, there must be sufficient TLAC to meet a leverage ratio requirement of 6% from 1 January 2019, rising to 6.75% by 1 January 2022.

Leverage Ratio
(Unaudited)

Basel III introduces a simple non risk-based leverage ratio as a complementary measure to the risk-based capital requirements to limit excessive leverage on the part of banks. The leverage ratio was introduced into the Basel III framework as a non-risk-based backstop limit, to supplement risk-based capital requirements. It aims to constrain the build-up of excess leverage in the banking sector, introducing additional safeguards against model risk and measurement errors. The ratio is a volume-based measure calculated as Basel III tier 1 capital divided by total on-and off-balance sheet exposures.

Basel III provides for a transitional period for the introduction of this ratio, comprising a supervisory monitoring period that started in 2011 and a parallel run period from January 2013 to January 2017. The parallel run will be used to assess whether the proposed minimum ratio of 3% is appropriate, with a view to migrating to a Pillar 1 requirement from 1 January 2018.

Capital (continued)

The group is required under rule 45A(6) of the Banking (Disclosure) Rules to disclose its leverage ratio calculated on a consolidated basis.

	At 31 December 2015	At 31 December 2014
	%	%
Leverage ratio	**6.4**	6.0

Capital and leverage ratio exposure measure		
	HK$m	HK$m
Tier 1 capital	**418,758**	389,745
Total exposure measure	**6,514,618**	6,490,577

The increase in the leverage ratio from 31 December 2014 to 31 December 2015 was mainly due to an increase in tier 1 capital during the year.

Further details regarding the group's leverage positions are set out in the Supplementary Notes Appendices on the Financial Statements 2015, Appendix 4 'Leverage Ratio Common Disclosure Template' and Appendix 5 'Leverage Ratio Summary Comparison Table' of the Supplementary Notes Appendices, which is available in the Regulatory Disclosures section of our website: www.hsbc.com.hk .

Capital adequacy at 31 December 2015
(Unaudited)

The following tables show the capital ratios, risk weighted assets ('RWAs') and capital base as contained in the 'Capital Adequacy Ratio' return submitted to the HKMA on a consolidated basis under the requirements of section 3C(1) of the Banking (Capital) Rules.

The basis of consolidation for financial accounting purposes is described in note 1 on the Financial Statements and differs from that used for regulatory purposes. Further information on the regulatory consolidation basis is set out in the Supplementary Notes on the Financial Statements 2015 and a full reconciliation between the group's accounting and regulatory balance sheets can be viewed in the Supplementary Notes Appendices on the Financial Statements 2015 that can be found in the Regulatory Disclosures section of our website www.hsbc.com.hk. Subsidiaries not included in consolidation for regulatory purposes are securities and insurance companies and the capital invested by the group in these subsidiaries is deducted from regulatory capital.

The Bank and its banking subsidiaries maintain regulatory reserves to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2015, the effect of this requirement is to reduce the amount of reserves which can be distributed to shareholders by HK$27,819m (31 December 2014: HK$27,959m).

There are no relevant capital shortfalls in any of the group's subsidiaries at 31 December 2015 (31 December 2014: Nil) which are not included in its consolidation group for regulatory purposes.

Capital ratios

(Unaudited)

	At 31 December 2015	At 31 December 2014
	%	%
Common Equity Tier 1 ('CET1') capital ratio	**15.6**	14.4
Tier 1 capital ratio	**16.6**	14.4
Total capital ratio	**18.6**	15.7

Risk weighted assets by risk type

(Unaudited)

	At 31 December 2015	At 31 December 2014
	HK$m	HK$m
Credit risk		
– Standardised approach	**235,235**	248,891
– IRB approach	**1,701,500**	1,811,343
– IRB (securitisation) approach	**5,695**	4,453
Counterparty credit risk		
– Standardised approach	**5,003**	6,406
– IRB approach	**98,229**	113,801
– Central Clearing Counterparty ('CCP')	**3,511**	8,435
– Credit Valuation Adjustment ('CVA')	**70,021**	81,061
Market risk	**101,551**	143,199
Operational risk	**298,662**	290,342
Total	**2,519,407**	2,707,931

Risk weighted assets by global business

(Unaudited)

	At 31 December 2015	At 31 December 2014
	HK$m	HK$m
Retail Banking and Wealth Management	**333,802**	301,844
Commercial Banking	**811,835**	876,596
Global Banking and Markets	**1,073,717**	1,239,715
Global Private Banking	**26,064**	24,256
Other	**273,989**	265,520
Total	**2,519,407**	2,707,931

RWA Planning

(Unaudited)

Pre-tax return on RWAs is an operational metric by which the global businesses are managed on a day-to-day basis. The metric combines return on equity and regulatory capital efficiency objectives.

Business performance against the targets is monitored through reporting to the Asset and Liability Management Committee of the group. The management of capital deductions is also addressed in the RWA monitoring framework through notional charges for these items, enabling a more holistic approach to performance measurement. A range of analysis is employed in the RWA monitoring framework to identify the key drivers of movements in the position, such as book size and book quality. Particular attention is paid to identifying and segmenting items within the day-to-day control of the business and those items that are driven by changes in risk models or regulatory methodology.

Capital Base

(Unaudited)

The following table sets out the composition of the group's capital base under Basel III at 31 December 2015. The position at 31 December 2015 benefits from transitional arrangements which will be phased out.

Capital (continued)

Capital adequacy at 31 December 2015

Capital base
(Unaudited)

	At 31 December 2015 HK$m	At 31 December 2014 HK$m
Common Equity Tier 1 ('CET1') capital		
Shareholders' equity	**514,078**	491,545
Shareholders' equity per balance sheet	**584,201**	557,835
Revaluation reserve capitalisation issue	**(1,454)**	(1,454)
Other equity instruments	**(14,737)**	(14,737)
Unconsolidated subsidiaries	**(53,932)**	(50,099)
Non-controlling interests	**22,352**	27,971
Non-controlling interests per balance sheet	**51,685**	50,511
Non-controlling interests in unconsolidated subsidiaries	**(5,717)**	(4,873)
Surplus non-controlling interests disallowed in CET1	**(23,616)**	(17,667)
Regulatory deductions to CET1 capital	**(142,611)**	(129,771)
Valuation adjustments	**(1,845)**	(2,030)
Goodwill and intangible assets	**(14,032)**	(14,683)
Deferred tax assets net of deferred tax liabilities	**(1,863)**	(1,485)
Cash flow hedging reserve	**(51)**	182
Changes in own credit risk on fair valued liabilities	**(940)**	(596)
Defined benefit pension fund assets	**(40)**	(89)
Significant capital investments in unconsolidated financial sector entities	**(39,524)**	(28,866)
Property revaluation reserves[1]	**(56,497)**	(52,657)
Regulatory reserve	**(27,819)**	(27,959)
Excess AT1 deductions	**–**	(1,588)
Total CET1 capital	**393,819**	389,745
Additional Tier 1 ('AT1') capital		
Total AT1 capital before regulatory deductions	**50,826**	48,750
Perpetual subordinated loans	**14,737**	14,737
Perpetual non-cumulative preference shares	**25,213**	25,229
Allowable non-controlling interests in AT1 capital	**10,876**	8,784
Regulatory deductions to AT1 capital	**(25,887)**	(48,750)
Significant capital investments in unconsolidated financial sector entities	**(25,887)**	(50,338)
Excess AT1 deductions	**–**	1,588
Total AT1 capital	**24,939**	–
Total Tier 1 capital	**418,758**	389,745
Tier 2 capital		
Total Tier 2 capital before regulatory deductions	**79,164**	88,802
Perpetual cumulative preference shares	**3,100**	3,102
Cumulative term preferences shares	**8,138**	8,143
Perpetual subordinated debt	**6,204**	9,337
Term subordinated debt	**21,603**	25,400
Property revaluation reserves[1]	**26,079**	24,350
Impairment allowances and regulatory reserve eligible for inclusion in Tier 2 capital	**14,040**	14,957
Allowable non-controlling interests in Tier 2 capital	**–**	3,513
Regulatory deductions to Tier 2 capital	**(29,059)**	(53,510)
Significant capital investments in unconsolidated financial sector entities	**(29,059)**	(53,510)
Total Tier 2 capital	**50,105**	35,292
Total capital	**468,863**	425,037

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

A detailed breakdown of the group's CET1 capital, AT1 capital, Tier 2 capital and regulatory deductions can be viewed in the Supplementary Notes Appendices on the Financial Statements 2015 that can be found in the Regulatory Disclosures section of our website www.hsbc.com.hk .

The following table shows the pro-forma Basel III end point basis position once all transitional arrangements have been phased out based on the Transition Disclosures Template. It should be noted that the pro-forma Basel III end point basis position takes no account of, for example, any future profits or management actions. In addition, the current regulations or their application may change before full implementation. Given this, the final impact on the group's capital ratios may differ from the pro-forma position, which is a mechanical application of the current rules to the balance sheet at 31 December 2015; it is not a projection. On this pro-forma basis, the group's CET1 ratio is 13.6% (2014: 10.7%), which is above the Basel III minimum requirement, plus expected regulatory capital buffer requirements.

Reconciliation of capital from transitional basis to a pro-forma Basel III end point basis

	At 31 December 2015 HK$m	At 31 December 2014 HK$m
CET1 capital on a transitional basis	**393,819**	389,745
Transitional provisions:		
Significant capital investments in unconsolidated financial sector entities	**(51,774)**	(100,676)
Excess AT1 deductions	**–**	1,588
CET1 capital end point basis	**342,045**	290,657
AT1 capital on a transitional basis	**24,939**	–
Grandfathered instruments:		
Perpetual non-cumulative preference shares	**(25,213)**	(25,229)
Transitional provisions:		
Allowable non-controlling interests in AT1 capital	**(9,494)**	(5,389)
Significant capital investments in unconsolidated financial sector entities	**25,887**	50,338
Excess AT1 deductions	**–**	(1,588)
AT1 capital end point basis	**16,119**	18,132
Tier 2 capital on a transitional basis	**50,105**	35,292
Grandfathered instruments:		
Perpetual cumulative preference shares	**(3,100)**	(3,102)
Cumulative term preference shares	**(8,138)**	(8,143)
Perpetual subordinated debt	**(6,204)**	(9,337)
Term subordinated debt	**(1,607)**	(6,787)
Transitional provisions:		
Significant capital investments in unconsolidated financial sector entities	**25,887**	50,338
Tier 2 capital end point basis	**56,943**	58,261

Capital (continued)

Capital instruments

(Unaudited)

The following is a summary of the group's CET1, AT1 and Tier 2 capital instruments at 31 December 2015.

2015	**Issued/Par value**	**Amount recognised in regulatory capital HK$m**
CET1 capital instruments		
Ordinary shares:		
38,420,982,901 issued and fully paid ordinary shares	HK$96,052m	**94,598**
AT1 capital instruments		
Floating rate perpetual subordinated loans, callable from 2019	US$1,900m	**14,737**
Perpetual non-cumulative preference shares	US$3,253m	**25,213**
Tier 2 capital instruments		
Perpetual cumulative preference shares	US$400m	**3,100**
Cumulative preference shares due 2024	US$1,050m	**8,138**
Primary capital undated floating rate notes	US$800m	**6,204**
Subordinated loan due 2022	US$300m	**2,325**
Subordinated loan due 2023	US$500m	**3,875**
Subordinated loan due 2024, callable from 2019	US$1,600m	**12,401**
Subordinated loan due 2025, callable from 2020	US$180m	**1,395**
Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017	MYR500m	**801**
Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022	MYR500m	**806**
		21,603
2014		
CET1 capital instruments		
Ordinary shares:		
38,420,982,901 issued and fully paid ordinary shares	HK$96,052m	94,598
AT1 capital instruments		
Floating rate perpetual subordinated loans, callable from 2019	US$1,900m	14,737
Perpetual non-cumulative preference shares	US$3,253m	25,229
Tier 2 capital instruments		
Perpetual cumulative preference shares	US$400m	3,102
Cumulative preference shares due 2024	US$1,050m	8,143
Primary capital undated floating rate notes	US$1,200m	9,337
Subordinated loan due 2021	US$450m	3,490
Subordinated loan due 2022	US$300m	2,326
Subordinated loan due 2023	US$500m	3,878
Subordinated loan due 2024, callable from 2019	US$1,600m	12,409
Floating rate subordinated notes due 2020, callable from 2015	AUD200m	1,178
Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017	MYR500m	1,056
Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022	MYR500m	1,063
		25,400

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

Statement of Directors' Responsibilities

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on page 78, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditor in relation to the Financial Statements.

The Directors of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') are responsible for the preparation of the Bank's *Annual Report and Accounts*, which contains the consolidated financial statements of the Bank and its subsidiaries (together 'the group'), in accordance with applicable law and regulations.

The Hong Kong Companies Ordinance requires the Directors to prepare for each financial year the consolidated financial statements for the group, and the balance sheet for the Bank.

The Directors are responsible for ensuring adequate accounting records are kept that are sufficient to show and explain the group's transactions, such that the group's financial statements give a true and fair view.

The Directors are responsible for preparing the consolidated financial statements that give a true and fair view and are in accordance with Hong Kong Financial Reporting Standards ('HKFRSs') issued by the Hong Kong Institute of Certified Public Accountants. The Directors have elected to prepare the Bank's balance sheet on the same basis.

The Directors, the names of whom are set out in 'Report of the Directors' on page 3 of this *Annual Report and Accounts*, confirm to the best of their knowledge that:

- the consolidated financial statements, which have been prepared in accordance with HKFRSs, have been prepared in accordance with the applicable set of accounting standards and give a true and fair view of the assets, liabilities, financial position and profit or loss of the group and the undertakings included in the consolidation taken as a whole; and
- the management report represented by the Financial Review, the Risk and Capital Reports include a fair review of the development and performance of the business and the position of the group and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that the group faces.

On behalf of the Board

Stuart Gulliver
Chairman
22 February 2016

Independent auditor's report to the shareholder of The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong with limited liability)

We have audited the consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited (the 'Bank') and its subsidiaries set out on pages 79 to 195, which comprise the consolidated balance sheet as at 31 December 2015, and the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows 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 ('HKICPA'), 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 and to report our opinion solely to you, as a body, in accordance with section 405 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 HKICPA. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, 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 financial position of the Bank and its subsidiaries as at 31 December 2015, and of their financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

PricewaterhouseCoopers
Certified Public Accountants

Hong Kong
22 February 2016

Financial Statements

Financial Statements

Consolidated income statement for the year ended 31 December 2015

	Note	**2015 HK$m**	2014 HK$m
Interest income	*4a*	**124,060**	126,782
Interest expense	*4b*	**(29,683)**	(31,673)
Net interest income		**94,377**	95,109
Fee income		**51,926**	50,662
Fee expense		**(6,267)**	(6,040)
Net fee income	*4c*	**45,659**	44,622
Net trading income	*4d*	**23,616**	20,220
Net income/(expense) from financial instruments designated at fair value	*4e*	**(2,560)**	4,048
Gains less losses from financial investments	*4f*	**11,611**	2,389
Dividend income	*4g*	**210**	1,374
Net insurance premium income	*5b*	**52,593**	57,307
Other operating income	*4h*	**10,439**	8,502
Total operating income		**235,945**	233,571
Net insurance claims and benefits paid and movement in liabilities to policyholders	*5c*	**(52,431)**	(60,182)
Net operating income before loan impairment charges and other credit risk provisions		**183,514**	173,389
Loan impairment charges and other credit risk provisions	*4i*	**(5,074)**	(4,925)
Net operating income		**178,440**	168,464
Employee compensation and benefits	*6a*	**(41,126)**	(38,894)
General and administrative expenses	*4j*	**(29,883)**	(28,278)
Depreciation of property, plant and equipment	*23a*	**(4,380)**	(4,107)
Amortisation and impairment of intangible assets	*22c*	**(1,602)**	(1,671)
Total operating expenses		**(76,991)**	(72,950)
Operating profit		**101,449**	95,514
Share of profit in associates and joint ventures		**15,830**	15,675
Profit before tax		**117,279**	111,189
Tax expense	*7a*	**(17,296)**	(19,012)
Profit for the year		**99,983**	92,177
Profit attributable to shareholders of the parent company		**89,533**	86,428
Profit attributable to non-controlling interests		**10,450**	5,749

Consolidated statement of comprehensive income for the year ended 31 December 2015

	2015 HK$m	2014 HK$m
Profit for the year	**99,983**	92,177
Other comprehensive income/(expense)		
Items that will subsequently be reclassified to the income statement when specific conditions are met:		
Available-for-sale investments:		
– fair value changes taken to equity	**(2,430)**	24,365
– fair value changes transferred to the income statement on disposal	**(15,637)**	(4,632)
– amounts transferred to the income statement on impairment	**8**	2,140
– fair value changes transferred to the income statement on hedged items	**37**	(311)
– income taxes	**354**	(1,378)
Cash flow hedges:		
– fair value changes taken to equity	**1,662**	3,870
– fair value changes transferred to the income statement	**(1,433)**	(4,429)
– income taxes	**(97)**	189
Share of other comprehensive income of associates and joint ventures	**460**	326
Exchange differences	**(19,188)**	(8,033)
Items that will not subsequently be reclassified to the income statement:		
Property revaluation:		
– fair value changes taken to equity	**6,601**	4,510
– income taxes	**(1,101)**	(731)
Remeasurement of defined benefit:		
– before income taxes	**(662)**	(704)
– income taxes	**105**	41
Other comprehensive income/(expense) for the year, net of tax	**(31,321)**	15,223
Total comprehensive income for the year, net of tax	**68,662**	107,400
Total comprehensive income for the year attributable to:		
– shareholders of the parent company	**63,447**	94,181
– non-controlling interests	**5,215**	13,219
	68,662	107,400

Financial Statements (continued)

Consolidated balance sheet at 31 December 2015

	Note	2015 HK$m	2014 HK$m
ASSETS			
Cash and sight balances at central banks	9	**151,103**	156,475
Items in the course of collection from other banks		**25,020**	21,122
Hong Kong Government certificates of indebtedness	10	**220,184**	214,654
Trading assets	11	**302,626**	407,026
Derivatives	12	**380,955**	389,934
Financial assets designated at fair value	13	**99,095**	98,195
Reverse repurchase agreements – non-trading	14	**212,779**	218,901
Placings with and advances to banks		**421,221**	488,313
Loans and advances to customers	15	**2,762,290**	2,815,216
Financial investments	18	**1,716,046**	1,456,493
Amounts due from Group companies		**244,396**	191,694
Interests in associates and joint ventures	21	**122,438**	116,654
Goodwill and intangible assets	22	**49,568**	45,078
Property, plant and equipment	23	**110,064**	104,679
Deferred tax assets	7	**1,836**	1,436
Other assets	25	**134,062**	150,876
Total assets		**6,953,683**	6,876,746
LIABILITIES			
Hong Kong currency notes in circulation	10	**220,184**	214,654
Items in the course of transmission to other banks		**30,753**	31,331
Repurchase agreements – non-trading	14	**16,158**	28,379
Deposits by banks		**148,294**	226,713
Customer accounts	26	**4,640,076**	4,479,992
Trading liabilities	27	**191,851**	215,812
Derivatives	12	**369,419**	367,128
Financial liabilities designated at fair value	28	**50,770**	48,834
Debt securities in issue	29	**40,859**	45,297
Retirement benefit liabilities	6c	**5,809**	5,606
Amounts due to Group companies		**110,073**	135,814
Other liabilities and provisions	30	**86,920**	87,731
Liabilities under insurance contracts	31	**340,820**	310,182
Current tax liabilities	7	**2,456**	2,927
Deferred tax liabilities	7	**18,799**	18,586
Subordinated liabilities	33	**8,003**	12,832
Preference shares	34	**36,553**	36,582
Total liabilities		**6,317,797**	6,268,400
EQUITY			
Share capital	35	**96,052**	96,052
Other equity instruments	36	**14,737**	14,737
Other reserves		**93,031**	107,985
Retained profits		**380,381**	339,061
Total shareholders' equity		**584,201**	557,835
Non-controlling interests		**51,685**	50,511
Total equity		**635,886**	608,346
Total equity and liabilities		**6,953,683**	6,876,746

Directors
Stuart Gulliver
Peter Wong

Consolidated statement of changes in equity for the year ended 31 December 2015

	2015										
				Other reserves							
	Share capital HK$m	Other equity instruments[6] HK$m	Retained profits HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange reserve[4] HK$m	Other[5] HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	96,052	14,737	339,061	48,481	16,537	(166)	1,872	41,261	557,835	50,511	608,346
Profit for the year	–	–	89,533	–	–	–	–	–	89,533	10,450	99,983
Other comprehensive income (net of tax)	–	–	(929)	5,146	(11,657)	131	(18,863)	86	(26,086)	(5,235)	(31,321)
Available-for-sale investments	–	–	–	–	(12,032)	–	–	–	(12,032)	(5,636)	(17,668)
Cash flow hedges	–	–	–	–	–	131	–	–	131	1	132
Property revaluation	–	–	(238)	5,146	–	–	–	–	4,908	592	5,500
Actuarial losses on defined benefit plans	–	–	(690)	–	–	–	–	–	(690)	133	(557)
Share of other comprehensive income of associates and joint ventures	–	–	(1)	–	375	–	–	86	460	–	460
Exchange differences	–	–	–	–	–	–	(18,863)	–	(18,863)	(325)	(19,188)
Total comprehensive income for the year	–	–	88,604	5,146	(11,657)	131	(18,863)	86	63,447	5,215	68,662
Dividends paid[7]	–	–	(37,405)	–	–	–	–	–	(37,405)	(4,053)	(41,458)
Movement in respect of share-based payment arrangements	–	–	7	–	–	–	–	345	352	4	356
Other movements	–	–	(4)	(14)	–	–	–	(10)	(28)	8	(20)
Transfers[8]	–	–	(9,882)	(1,514)	–	–	–	11,396	–	–	–
At 31 December	96,052	14,737	380,381	52,099	4,880	(35)	(16,991)	53,078	584,201	51,685	635,886

Financial Statements (continued)

Consolidated statement of changes in equity for the year ended 31 December 2015 *(continued)*

	2014										
				Other reserves							
	Share capital HK$m	Other equity instruments[6] HK$m	Retained profits HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange reserve[4] HK$m	Other[5] HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	85,319	–	305,926	46,336	3,280	197	9,619	30,132	480,809	41,415	522,224
Profit for the year	–	–	86,428	–	–	–	–	–	86,428	5,749	92,177
Other comprehensive income (net of tax)	–	–	(930)	3,540	13,255	(363)	(7,747)	(2)	7,753	7,470	15,223
Available-for-sale investments	–	–	–	–	12,932	–	–	–	12,932	7,252	20,184
Cash flow hedges	–	–	–	–	–	(363)	–	–	(363)	(7)	(370)
Property revaluation	–	–	(220)	3,540	–	–	–	–	3,320	459	3,779
Actuarial losses on defined benefit plans	–	–	(715)	–	–	–	–	–	(715)	52	(663)
Share of other comprehensive income of associates and joint ventures	–	–	5	–	323	–	–	(2)	326	–	326
Exchange differences	–	–	–	–	–	–	(7,747)	–	(7,747)	(286)	(8,033)
Total comprehensive income for the year	–	–	85,498	3,540	13,255	(363)	(7,747)	(2)	94,181	13,219	107,400
Shares issued	10,733	–	–	–	–	–	–	–	10,733	–	10,733
Other equity instruments issued	–	14,737	–	–	–	–	–	–	14,737	–	14,737
Dividends paid	–	–	(42,750)	–	–	–	–	–	(42,750)	(3,981)	(46,731)
Movement in respect of share-based payment arrangements	–	–	(141)	–	–	–	–	261	120	5	125
Other movements	–	–	6	–	(1)	–	–	–	5	(147)	(142)
Transfers[8]	–	–	(9,478)	(1,395)	3	–	–	10,870	–	–	–
At 31 December	96,052	14,737	339,061	48,481	16,537	(166)	1,872	41,261	557,835	50,511	608,346

Consolidated statement of changes in equity for the year ended 31 December 2015 *(continued)*

1 *The property revaluation reserve represents the difference between the fair value of the property and its depreciated cost.*
2 *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.*
3 *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.*
4 *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.*
5 *The other reserves mainly comprise of the share-based payment reserve account, purchase premium arising from transfer of business within the HSBC Group 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.*
6 *During 2014, the Bank issued new capital instruments that are included in the group's capital base as Basel III-compliant additional tier 1 capital under the Banking (Capital) Rules.*
7 *Including distributions paid on perpetual subordinated loans classified as equity under HKFRSs.*
8 *The movement from Retained profits to Other reserves includes the relevant transfers in associates according to local regulatory requirements.*

Financial Statements (continued)

Consolidated statement of cash flows for the year ended 31 December 2015

	Note	2015 HK$m	2014 HK$m
Operating activities			
Cash generated from operations	39	**168,508**	61,780
Interest received on financial investments		**15,201**	14,891
Dividends received on financial investments		**212**	1,466
Dividends received from associates		**4,990**	4,765
Taxation paid		**(17,020)**	(17,546)
Net cash inflow from operating activities		**171,891**	65,356
Investing activities			
Purchase of financial investments		**(579,361)**	(403,722)
Proceeds from sale or redemption of financial investments		**462,793**	385,353
Purchase of property, plant and equipment		**(3,687)**	(2,864)
Proceeds from sale of property, plant and equipment and assets held for sale		**355**	180
Purchase of other intangible assets		**(1,796)**	(1,546)
Net cash inflow from the sale of interests in business portfolios	40c	**5,092**	2,882
Net cash outflow from investing activities		**(116,604)**	(19,717)
Net cash inflow before financing activities		**55,287**	45,639
Financing activities			
Issue of ordinary share capital		**–**	10,733
Issue of other equity instruments		**–**	14,737
Issue of subordinated liabilities		**1,395**	12,409
Redemption of preference shares		**–**	(10,733)
Repayment of subordinated liabilities		**(7,704)**	(6,010)
Ordinary dividends paid	8	**(36,750)**	(42,750)
Dividends paid on perpetual subordinated loans	8	**(655)**	–
Dividends paid to non-controlling interests		**(4,053)**	(3,981)
Interest paid on preference shares		**(864)**	(1,108)
Interest paid on subordinated liabilities		**(1,004)**	(1,056)
Net cash outflow from financing activities		**(49,635)**	(27,759)
Increase in cash and cash equivalents	40a	**5,652**	17,880

Notes on the Financial Statements

1 Basis of preparation

a Compliance with Hong Kong Financial Reporting Standards

Hong Kong Financial Reporting Standards (‘HKFRSs’) comprise 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 of the group have been prepared in accordance with HKFRSs and accounting principles generally accepted in Hong Kong. These financial statements also comply with the requirements of the Hong Kong Companies Ordinance (Cap. 622) (‘new Companies Ordinance’) which are applicable to the preparation of financial statements.

Standards adopted during the year ended 31 December 2015

There were no new standards adopted during the year ended 31 December 2015.

During 2015, the group adopted a number of amendments to standards which had an insignificant effect on the consolidated financial statements.

New Companies Ordinance

The requirements of Part 9 ‘Accounts and Audit’ of the new Companies Ordinance came into operation during the financial year. As a result there are changes to the presentation and disclosure of certain information in the group’s financial statements.

b Presentation of information

Disclosures under HKFRS 4 ‘Insurance Contracts’ and HKFRS 7 ‘Financial Instruments: Disclosures’ concerning the nature and extent of risks relating to insurance contracts and financial instruments are included in the audited sections of the ‘Risk Report’ on pages 23 to 69.

Capital disclosures under HKAS 1 ‘Presentation of Financial Statements’ are included in the audited sections of ‘Capital’ on pages 70 to 76.

In accordance with the group’s policy to provide disclosures that help stakeholders understand the group’s performance, financial position and changes thereto, the information provided in the Notes on the Financial Statements, the Risk Report and the Capital section goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements. In particular, the group provides additional disclosures having regard to the recommendations of the Enhanced Disclosure Task Force (‘EDTF’). The report aims to help financial institutions identify areas that users had highlighted a need for better and more transparent information about banks’ risks, and how these risks relate to performance measurement and reporting.

Certain comparative figures have been re-presented to conform to current year presentation. Refer to note 50 for further details.

1 Basis of preparation *(continued)*

c Consolidation

The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Control is initially assessed based on consideration of all facts and circumstances, and is subsequently reassessed when there are significant changes to the initial setup.

Where an entity is governed by voting rights, the group would consolidate when it holds, directly or indirectly, the necessary voting rights to pass resolutions by the governing body. In all other cases, the assessment of control is more complex and requires judgement of other factors, including having exposure to variability of returns, power over relevant activities or holding the power as agent or principal.

Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured at the fair value of the consideration, including contingent consideration, given at the date of exchange. Acquisition-related costs are recognised as an expense in the income statement in the period in which they are incurred. The acquired identifiable assets, liabilities and contingent liabilities are generally measured at their fair values at the date of acquisition. Goodwill is measured as the excess of the aggregate of the consideration transferred, the amount of non-controlling interest and the fair value of the group's previously held equity interest, if any, over the net of the amounts of the identifiable assets acquired and the liabilities assumed. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. For acquisitions achieved in stages, the previously held equity interest is remeasured at the acquisition-date fair value with the resulting gain or loss recognised in the income statement.

All intra-group transactions are eliminated on consolidation.

The consolidated financial statements also include the attributable share of the results and reserves of associates and joint ventures based on the financial statements prepared at dates not earlier than three months prior to 31 December 2015.

d Future accounting developments

At 31 December 2015, a number of standards and amendments to standards had been issued by the HKICPA, which are not effective for the group's consolidated financial statements as at 31 December 2015. The group does not expect that they will have a significant effect, when applied, on the group's financial statements, apart from those that are discussed in more detail below. In addition to completing its projects on financial instrument accounting and revenue recognition discussed below, the HKICPA is working on projects on insurance and lease accounting which could represent significant changes to accounting requirements in the future.

In July 2014, the HKICPA issued HKFRS 15 'Revenue from Contracts with Customers'. The original effective date of HKFRS 15 has been delayed by one year and the standard is now effective for annual periods beginning on or after 1 January 2018 with early application permitted. HKFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognising revenue for obligations as they are satisfied. The standard should be applied retrospectively, with certain practical expedients available. The group is currently assessing the impact of this standard but it is not practicable to quantify the effect as at the date of the publication of these financial statements.

In September 2014, the HKICPA issued HKFRS 9 'Financial Instruments', which is the comprehensive standard to replace HKAS 39 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

1 Basis of preparation *(continued)*

Classification and measurement

The classification and measurement of financial assets will depend on the entity's business model for their management and their contractual cash flow characteristics and result in financial assets being classified and measured at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss. In many instances, the classification and measurement outcomes will be similar to HKAS 39, although some differences will arise. For example, since HKFRS 9 does not apply embedded derivative accounting to financial assets, certain financial assets and equity securities will be measured at fair value through profit or loss or, in limited circumstances, at FVOCI. The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in population of financial assets measured at amortised cost or fair value compared with HKAS 39. The classification of financial liabilities is essentially unchanged, except that, for certain liabilities measured at fair value, gains or losses relating to changes in the entity's own credit risk are to be included in other comprehensive income.

Impairment

The impairment requirements apply to financial assets measured at amortised cost, FVOCI, lease receivables, certain loan commitments and financial guarantee contracts. At initial recognition, allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12 month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL').

The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period by considering the probability of default occurring over the remaining life of the financial instrument, rather than by considering an increase in ECL.

The assessment of credit risk, as well as the estimation of ECL, are required to be unbiased, probability-weighted, and should incorporate all available information which is relevant to the assessment, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under HKAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with HKAS 39.

Hedge accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link between it and risk management strategy and permitting the former to be applied to a greater variety of hedging instruments and risks. The standard does not explicitly address macro hedge accounting strategies, which are being considered in a separate project. To remove the risk of any conflict between existing macro hedge accounting practice and the new general hedge accounting requirements, HKFRS 9 includes an accounting policy choice to remain with HKAS 39 hedge accounting.

The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement to restate comparative periods. Hedge accounting is generally applied prospectively from that date.

The mandatory application date for the standard as a whole is 1 January 2018, but it is possible to apply the revised presentation for certain liabilities measured at fair value from an earlier date. The group intends to revise the presentation of fair value gains and losses relating to the entity's own credit risk on certain liabilities. If this presentation was applied at 31 December 2015, the effect would be to increase or decrease profit before tax with the opposite effect to be reported on other comprehensive income based on the change in fair value attributable to changes in the group's credit risk for the year, with no effect on net assets. Further information on change in fair value attributable to changes in credit risk, including the group's credit risk, is disclosed in note 28.

Notes on the Financial Statements (continued)

1 Basis of preparation *(continued)*

The group is currently assessing the impact that the rest of HKFRS 9 will have on the financial statements through a groupwide project which has been in place since 2012, but due to the complexity of the classification and measurement, impairment, and hedge accounting requirements and their inter-relationships, it is not possible at this stage to quantify the potential effect.

e Going concern

The financial statements are prepared on a going concern basis, as the Directors are satisfied that the group has the resources to continue in business for the foreseeable future. In making this assessment, the Directors have considered a wide range of information relating to present and future conditions, including future projections of profitability, cash flows and capital resources.

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(e), involves considerable judgement and estimation.

For individually assessed loans, judgement is required in determining whether there are indications that an impairment loss may already have been incurred and then estimating the amount and timing of expected cash flows, which form the basis of the impairment loss that is recorded.

For collectively assessed loans, judgement is involved in selecting and applying the criteria for grouping together loans with similar credit characteristics, as well as in selecting and applying the statistical and other models used to estimate the losses incurred for each group of loans in the reporting period. The benchmarking of loss rates, the assessment of the extent to which historical losses are representative of current conditions and the ongoing refinement of modelling methodologies provide a means of identifying changes that may be required, but the process is inherently one of estimation.

Valuation of financial instruments

The best evidence of fair value is a quoted price in an actively traded principal market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and quoted price. 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. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including:

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

- the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate;
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. 'Projection' utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products are dependent on more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may affect the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates. For interest rate derivatives with collateralised counterparties and in significant currencies, the group uses a discounting curve that reflects the overnight interest rate ('OIS discounting').

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more 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 inception profit or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

The group's accounting policy for valuation of financial instruments is included in note 3(i) and is discussed further in note 48 'Fair values of financial instruments carried at fair value'.

Interests in associates

Determining whether an investment in another entity should be classified as an investment in an associate requires judgement. Management considers all aspects of the relationship between the investor and the investee in order to determine whether the group has significant influence over the investee. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies. Where significant influence exists, an investment is classified as an associate and is accounted for using the equity method, while an investment in an entity which is not an associate, joint venture, or subsidiary is accounted for either at fair value through profit and loss, or as an available-for-sale investment.

Under the equity accounting method, investments in associates are initially stated at cost, and are adjusted thereafter for the post-acquisition change in the group's share of the net assets of the associate. An investment in an associate is tested for impairment when there is an indication that the investment may be impaired. At 31 December 2015, the fair value of the group's investment in BoCom had been below the carrying amount for approximately 44 months, apart from a short period in 2013 and briefly during the first half of 2015. The conclusion of the impairment test, based on the assessment of the value in use, was that the investment is not impaired. The measurement of value in use involves significant judgements in estimating the present values of cash flows expected to arise from continuing to hold the investment. Note 21 includes detailed information on the group's investment in BoCom. It provides a description of the key assumptions used in estimating value in use, the sensitivity of the value in use calculation to different assumptions and a sensitivity analysis that shows the changes in key assumptions that would reduce the excess of value in use over the carrying amount ('headroom') to nil.

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

Liabilities under investment contracts

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

Insurance contracts

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 22(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.

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 (except for debt securities issued by the group and derivatives managed in conjunction with those debt securities) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method.

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.

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.

3 Summary of significant accounting policies *(continued)*

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, including liabilities under investment contracts;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value through profit or loss; and
- interest income, interest expense and dividend income in respect of:
  - financial assets and financial liabilities designated at fair value through profit or loss; and
  - derivatives managed in conjunction with the above,

  except for interest arising from debt securities issued by the group 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.

---

c *Operating segments*

The group has a matrix management structure. The group's chief operating decision-maker is the Executive Committee which regularly reviews operating activity on a number of bases, including by geography and by global business. The group considers that geographical operating segments represent the most appropriate information for the users of the financial statements to best evaluate the nature and financial effects of the business activities in which the group engages, and the economic environments in which it operates. This reflects the importance of geographic factors on business strategy and performance, the allocation of capital resources, and the role of geographical regional management in executing strategy. As a result, the group's operating segments are considered to be geographical regions.

Measurement of segmental assets, liabilities, income and expenses is in accordance with the group's accounting policies. Segmental income and expenses include transfers between segments and these transfers are conducted on arm's length terms and conditions. Shared costs are included in segments on the basis of the actual recharges made.

---

d *Loans and advances to banks and customers*

These include loans and advances originated by the group which are not classified as either held for trading or designated at fair value. They are recognised when cash is advanced to a borrower and derecognised when either the borrower repays its obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment allowance.

Loans and advances are reclassified to 'Assets held for sale' when they meet the criteria presented in note 3(ad); though their measurement continues to be measured in accordance with this policy.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. On drawdown, the loan is classified as held for trading. Where the group intends to hold the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. On inception of the loan, the loan to be held is recorded at its fair value and subsequently measured at amortised cost. For certain transactions, such as leveraged finance and syndicated lending activities, the cash advanced may not be 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, the difference is charged to the income statement in other operating income. The write-down is recovered over the life of the loan, through the recognition of interest income, unless the loan becomes impaired.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

e *Impairment of loans and advances*

Losses for impaired loans are promptly recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances that are calculated on individual loans and on groups of loans assessed collectively are recorded as charges to the income statement and are recorded against the carrying amount of impaired loans on the balance sheet. Losses which may arise from future events are not recognised.

Individually assessed loans and advances

The factors considered in determining whether a loan is individually significant for the purposes of assessing impairment include the size of the loan, the number of loans in the portfolio, and the importance of the individual loan relationship, and how this is managed.

Loans that are determined to be individually significant based on the above and other relevant factors will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to justify treatment under a collective methodology.

Loans considered as individually significant are typically to corporate and commercial customers, are for larger amounts and are managed on an individual basis. For these loans, the group considers 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 to make this assessment include:

- known cash flow difficulties experienced by the borrower;
- contractual payments of either principal or interest being past due for more than 90 days;
- the probability that the borrower will enter bankruptcy or other financial realisation;
- a concession granted to the borrower for economic or legal reasons relating to the borrower's financial difficulty that results in the forgiveness or postponement of principal, interest or fees, where the concession is not insignificant; and
- there has been deterioration in the financial condition or outlook of the borrower such that its ability to repay is considered doubtful.

For 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.

3 Summary of significant accounting policies *(continued)*

The determination of the realisable value of security is based on the most recently updated market value at the time the impairment assessment is performed. The value is not adjusted for expected future changes in market prices; though adjustments are made to reflect local conditions such as forced sale discounts.

Impairment losses are calculated by discounting the expected future cash flows of a loan, which includes expected future receipts of contractual interest, at the loan's original effective interest rate, or an approximation thereof, 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.

Collectively assessed loans and advances

Impairment is assessed collectively to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment or for homogeneous groups of loans that are not considered individually significant. Retail lending portfolios are generally assessed for impairment collectively as the portfolios are generally large homogeneous loan pools.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for a collective impairment assessment. These credit risk characteristics may include country of origination, type of business involved, type of products offered, security obtained or other relevant factors. This assessment captures 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. When information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed individually.

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 judgement 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 based on economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. As it is assessed empirically on a periodic basis, the estimated period may vary over time as these factors change.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

Homogeneous groups of loans and advances

Statistical methods are used to determine collective impairment losses for homogeneous groups of loans not considered individually significant. The methods that are used to calculate collective allowances are:

- When appropriate empirical information is available, the group utilises roll-rate methodology, which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date and which the group is not able to identify individually. Individual loans are grouped using ranges of past due days; statistical analysis is then used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics as described above. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring and its discovery, for example through a missed payment, (known as the emergence period) and the period of time between discovery and write-off (known as the outcome period). 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, or a discounted cash flow model. Where a basic formulaic approach is undertaken, management estimates that typically it takes between six and twelve months between a loss occurring and its identification.

The inherent loss within each portfolio is assessed on the basis of statistical models using historical data observations, which are updated periodically to reflect recent portfolio and economic trends. When the most recent trends arising from changes in economic, regulatory or behavioural conditions are not fully reflected in the statistical models, they are taken into account by adjusting the impairment allowances derived from the statistical models to reflect these changes as at the balance sheet date.

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.

3 Summary of significant accounting policies *(continued)*

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' at the carrying amounts of the assets classified as held for sale. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Write-downs of the acquired asset to fair value less cost to sell and any reversals of previous write-downs are recognised in the income statement in 'Other operating income', together with any realised gains or losses on disposal.

Renegotiated loans

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

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument. Any new loans that arise following derecognition events will continue to be disclosed as renegotiated loans and are assessed for impairment as above.

---

f *Trading assets and trading liabilities*

Treasury bills, loans and advances to and from customers, placings with and by banks, debt securities, structured deposits, equity shares, own debt issued and short positions in securities which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, are classified as held for trading. Financial assets and financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell the financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, the fair values are remeasured and gains and losses from changes therein are recognised in the income statement within 'Net trading income'.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

g *Financial instruments designated at fair value*

Financial instruments, other than those held for trading, are classified in this category if they meet the criteria set out below and are so designated irrevocably at inception. 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 instruments, or recognising the gains and losses under different bases from related positions. Under this criterion, the main classes of financial instruments designated by the group are:

  Long-term debt issues. The interest payable on certain fixed-rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement;

  Financial assets and financial liabilities under unit-linked insurance and unit-linked investment contracts. Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded in other comprehensive income. These financial instruments are managed on a fair value basis and management information is also prepared on this basis. Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line under the following categories:

- Groups of financial instruments that are managed and their performance evaluated, on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about those groups of financial instruments is reported to management on that basis. For example, certain financial assets are held to meet liabilities under non-linked insurance contracts, the group has documented risk management and investment strategies designed to manage and monitor market risk of those assets on a net basis, after considering non-linked liabilities. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations; and

- Financial instruments containing one or more non-closely related embedded derivatives.

Designated financial assets are recognised at fair value when the group enters into contracts with counterparties, which is generally on trade date, and are normally derecognised when sold. Subsequent changes in fair values are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

3 Summary of significant accounting policies *(continued)*

h *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. They are recognised on trade date when the group enters into contractual arrangements to purchase those instruments, and are normally derecognised when either the securities are sold or redeemed.

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 until they are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale debt securities using the effective interest rate method, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been irrevocably established.

Available-for-sale financial assets are assessed at each balance sheet date for objective evidence of impairment. If such evidence exists 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 has an impact which can be reliably measured on the estimated future cash flows of the financial asset, an impairment loss is recognised.

If the available-for-sale financial asset is impaired, the difference between its 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 recognised in the income statement.

Impairment losses are recognised in the income statement within 'Loan impairment charges and other credit risk provisions' for debt instruments and within 'Gains less losses from financial investments' for equities. The impairment methodologies for available-for-sale financial assets are set out as follows:

Available-for-sale debt securities

In assessing 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.

Financial difficulties of the issuer, as well as 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.

In addition, the performance of underlying collateral and the extent and depth of market price declines is relevant when assessing objective evidence of impairment of available-for-sale ABSs. The primary indicators of potential impairment are considered to be adverse fair value movements and the disappearance of an active market for a security, while changes in credit ratings are of secondary importance.

3 Summary of significant accounting policies *(continued)*

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.

Once an impairment loss has been recognised, the subsequent accounting treatment for changes in the fair value of that asset depends on the type of asset:

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income. 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, or the instrument is no longer impaired, the impairment loss is reversed through the income statement;
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised in other comprehensive income. 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.

Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends and is able 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, less any impairment losses.

i *Valuation of financial instruments*

All financial instruments are recognised initially at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of a financial instrument on initial recognition is generally its transaction price (that is, the fair value of the consideration given or received). However, sometimes the fair value will 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 at inception (‘day 1 gain or loss’), being the difference between the transaction price and the fair value. When significant unobservable parameters are used, the entire day 1 gain or loss is deferred and is recognised in the income statement over the life of the transaction until the transaction matures or is closed out, the valuation inputs become observable or the group enters into an offsetting transaction.

The fair value of financial instruments is generally measured on an individual basis. However, in cases where the group manages a group of financial assets and liabilities according to its net market or credit risk exposure, the fair value of the group of financial instruments is measured on a net basis but the underlying financial assets and liabilities are presented separately in the financial statements, unless they satisfy the HKFRS offsetting criteria as described in note 44.

3 Summary of significant accounting policies *(continued)*

j *Non-trading reverse repurchase and repurchase agreements*

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 an asset is recorded in respect of the initial consideration paid.

Non-trading repos and reverse repos are measured at amortised cost. The difference between the sale and repurchase price or between the purchase and resale price is treated as interest and recognised in net interest income over the life of the agreements.

---

k *Derivative financial instruments and hedge accounting*

Derivatives are financial instruments that derive their value from the price of underlying items such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity or other indices.

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of derivatives are obtained either from quoted market prices or by using valuation techniques.

Embedded derivatives are bifurcated from the host contract when their economic characteristics and risks are not clearly and closely related to those of the host non-derivative contract, their contractual terms would otherwise meet the definition of a stand-alone derivative and the combined contract is not held for trading or designated at fair value. The bifurcated 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 for accounting purposes if the offsetting criteria presented in note 3(m) are met.

Gains and losses from changes in the fair value of derivatives, including the contractual interest, that do not qualify for hedge accounting are reported in 'Net trading income'. Gains and losses on derivatives managed in conjunction with financial instruments designated at fair value are reported in 'Net income from financial instruments designated at fair value' together with the gains and losses on the economically hedged items. Where the derivatives are managed with debt securities issued by the group that are designated at fair value, the contractual interest is shown in 'Interest expense' together with the interest payable on the issued debt.

Hedge accounting

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').

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 requires documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items.

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 attributable to the hedged risk. If a hedging relationship no longer meets the criteria for hedge accounting, hedge accounting is discontinued; the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is recognised in 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; the ineffective portion is recognised immediately in the income statement within 'Net trading income'.

The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the same periods in which the hedged item affects profit or loss. In hedges of forecast transactions that result in recognition of a non-financial asset or liability, previous gains and losses recognised in other comprehensive income are included in the initial measurement of the asset or liability.

When a hedging relationship is discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss 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; the residual change in fair value 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, or part 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, both prospectively and retrospectively, on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed and the method adopted by an entity to assess hedge effectiveness will depend on its 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, with the effectiveness range being defined as 80% to 125%. Hedge ineffectiveness is recognised in the income statement in 'Net trading income'.

Derivatives that do not qualify for hedge accounting

Non-qualifying hedges are economic hedges entered into for which hedge accounting was not applied.

3 Summary of significant accounting policies *(continued)*

l *Derecognition of financial assets*

Financial assets are derecognised when the contractual rights to receive cash flows from the assets have expired; or when the group has transferred its contractual rights to receive the cash flows of the financial assets, and either:

- substantially all the risks and rewards of ownership have been transferred; or
- the group has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

---

m *Offsetting financial assets and financial liabilities*

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

---

n *Subsidiaries, associates and joint ventures*

The group classifies investments in entities which it controls as subsidiaries.

Investments in which the group, together with one or more parties, has joint control of an arrangement set up to undertake an economic activity are classified as joint ventures. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates.

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 less any impairment losses.

Profits on transactions between the group and its associates and joint ventures are eliminated to the extent of the group's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of the group's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

The Bank's investments in subsidiaries, associates and joint ventures are stated at cost less any impairment losses. An impairment loss recognised in prior periods shall be reversed through the income statement if, and only if, there has been a change in the estimates used to determine the recoverable amount of the investment since the last impairment loss was recognised.

In order to determine whether an impairment test under HKAS 36 'Impairment of Assets' is required in respect of an interest in an associate or a joint venture, it is necessary to consider the indicators in HKAS 39 'Financial Instruments: Recognition and Measurement'. Where the review of the indicators suggests that the interest in an associate or joint venture may be impaired, the impairment testing requirements of HKAS 36 are applied.

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, for example when any voting rights relate to administrative tasks only, and key activities are directed by contractual agreement. Structured entities often have restricted activities and a narrow and well-defined objective. Structured entities are assessed for consolidation in accordance with the accounting policy set out in note 1(c).

The group is considered to sponsor another entity if, in addition to ongoing involvement with the entity, it had a key role in establishing that entity or in bringing together the relevant counterparties so that the transaction, which is the purpose of the entity, could occur. The group is generally not considered a sponsor if the only involvement with the entity is merely administrative in nature.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

o *Goodwill and intangible assets*

(i) Goodwill arises on the acquisition of subsidiaries, when the aggregate of the fair value of the consideration transferred, the amount of any non-controlling interest and the fair value of any previously held equity interest in the acquiree exceeds the amount of the identifiable assets and liabilities acquired. If the amount of the identifiable assets and liabilities acquired is greater, the difference is recognised immediately in the income statement. Goodwill arises on the acquisition of interests in joint ventures and associates when the cost of investment exceeds the group's share of the net fair value of the associate's or joint venture's identifiable assets and liabilities.

Intangible assets are recognised, and those that are acquired in a business combination are distinguished from goodwill, when they are separable or arise from contractual or other legal rights, and it is probable that future economic benefits will flow to the group, the cost of which can be measured reliably.

Goodwill is allocated to cash-generating units ('CGU') 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, or whenever there is an indication of impairment, by comparing the recoverable amount with its carrying amount. The carrying amount of a CGU is based on its assets and liabilities, 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 CGU cash flows. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is carried on the balance sheet at cost less accumulated impairment losses.

Goodwill on acquisitions of interests in joint ventures and associates is included in 'Interests in associates and joint ventures' and is not tested separately for impairment.

At the date of disposal of a business, attributable goodwill is included in the group's share of net assets in the calculation of the gain or loss on disposal.

Goodwill is included in a disposal group if the disposal group is a CGU to which goodwill has been allocated or it is an operation within such a CGU. The amount of goodwill included in a disposal group is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained.

(ii) Intangible assets include the present value of in-force long-term insurance business, operating rights, computer software and, when acquired in a business combination, trade names, customer relationships and core deposit relationships. Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually.

Intangible assets that have a finite useful life, except for the present value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected economic life.

Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

The accounting policy on the present value of in-force long-term insurance business is set out in note 3(x).

3 Summary of significant accounting policies *(continued)*

p *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 to reliably separate the value of the building from the value of the leasehold land at inception of the lease are revalued by professional qualified valuers, on a depreciated replacement cost basis or surrender value, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value.

Depreciation on land and buildings is calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;
- leasehold land and buildings are depreciated over the shorter of the unexpired terms of the leases or the remaining useful lives; and
- freehold buildings and improvements thereto are depreciated at the greater of 2% per annum on a 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 based on the highest and best use of the property, primarily using the 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(q)).

(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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

(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.

---

q *Finance and operating leases*

(i) Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. Where the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to customers' as appropriate. Finance income receivable is recognised over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

(ii) Where the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. The finance lease and corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised over the periods of the leases based on the interest rates implicit in the leases so as to give a constant rate of interest on the remaining balance of the liability.

(iii) All other leases are classified as operating leases. Where the group is the lessor, the assets subject to the operating leases are included in 'Property, plant and equipment' and accounted for accordingly. Impairment losses are recognised to the extent that the carrying value of equipment is impaired through residual values not being fully recoverable. Where the group is the lessee, the leased assets are not recognised on the balance sheet.

(iv) Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the period of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

(v) Leasehold land is included under 'Other assets' in the balance sheet if such land is considered to be held under operating leases and is stated at cost less amortisation and impairment losses. Amortisation is calculated to write off the cost of the land on a straight-line basis over the terms of the leases.

---

r *Income tax*

(i) Income tax comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case it is recognised in the same statement in which the related item appears.

(ii) Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years. The group provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

3 Summary of significant accounting policies *(continued)*

(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 expected to apply when the assets will be realised or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when the group has a legal right to offset.

Deferred tax relating to actuarial gains and losses arising from post-employment benefit plans is recognised in other comprehensive income. Deferred tax relating to share-based payment transactions is recognised directly in equity to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense.

Deferred tax relating to changes in the fair value of available-for-sale investments and cash flow hedging instruments is charged or credited directly to other comprehensive income and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

---

s *Pension and other post-employment benefits*

The group operates a number of pension and post-employment 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 the employees render service.

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the schemes' actuaries using the projected unit credit method. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit liability and is presented in operating expenses.

The past service cost, which is charged immediately to the income statement, is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or curtailment (a significant reduction by the entity in the number of employees covered by a plan). A settlement is a transaction that eliminates all further legal and constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Re-measurements of the net defined benefit liability, which comprise actuarial gains and losses, return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in other comprehensive income.

Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions.

The defined benefit liability recognised on the balance sheet represents the present value of defined benefit obligations reduced by the fair value of plan assets. Any net defined benefit surplus is limited to the present value of available refunds and reductions in future contributions to the plan.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

t *Share-based payments*

The group enters into both equity-settled and cash-settled share-based payment arrangements with its employees as compensation for services provided by employees. The cost of equity-settled share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to 'Retained earnings'.

For cash-settled share-based payment arrangements, the services acquired and liability incurred are measured at the fair value of the liability and recognised as the employees render service. Until settlement, the fair value of the liability is re-measured, with changes in fair value recognised in the income statement.

Fair value is determined by using appropriate valuation models. Vesting conditions include service conditions and performance conditions; any other features of the arrangement are non-vesting conditions. Market performance conditions and non-vesting conditions are taken into account when estimating the fair value of the award at the date of grant. 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.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting and is recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

HSBC Holdings is the grantor of its equity instruments for all share awards and share options across the group. The credit to 'Other reserves' over the vesting period on expensing an award represents the effective capital contribution from HSBC Holdings. To the extent the group will be, or has been, required to fund a share-based payment arrangement, this capital contribution is reduced and the fair value of shares expected to be released to employees is recorded within 'Other liabilities'.

---

u *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 consolidated financial statements are presented in Hong Kong dollars which is also the Bank's functional currency.

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any foreign exchange component of a gain or loss on a non-monetary item is recognised either in other comprehensive income or in the income statement depending on where the gain or loss on the underlying non-monetary item is recognised.

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 foreign operation's separate 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 previously recognised in other comprehensive income are recognised in the income statement as a reclassification adjustment.

v *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 which has arisen as a result of past events and for which a reliable estimate can be made.

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security and contingent liabilities related to legal proceedings or regulatory matters, 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.

w *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 present value of the fee 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.

x *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.

Reinsurance premiums are accounted for in the same accounting period as the premiums for the direct insurance contracts to which they relate.

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long-term investment contracts with discretionary participating features ('DPF') and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the equity holders' interest in the profits expected to emerge from those contracts written at the balance sheet date.

The present value of in-force long-term insurance business and long-term investment contracts with DPF, referred to as 'PVIF', is determined by discounting the equity holders' interest in future profits expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in 'Other operating income' on a gross of tax basis.

3 Summary of significant accounting policies *(continued)*

Insurance 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.

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.

Reinsurance recoveries are accounted for in the same period as the related claim.

Liabilities under insurance contracts

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles. Some insurance contracts may contain discretionary participation features whereby the policyholder is entitled to additional payments whose amount and/or timing is at the discretion of the issuer. The discretionary element of these contracts is included in 'Liabilities under insurance contracts'.

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all 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.

---

y *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'.

---

z *Dividends*

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

---

aa *Debt securities in issue and subordinated liabilities*

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the consideration received, net of directly attributable transaction costs incurred. 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 rate method and are reported under 'Debt securities in issue' or 'Subordinated liabilities'.

3 Summary of significant accounting policies *(continued)*

ab *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.

ac *Share capital and other equity instruments*

Financial instruments issued are classified as equity when there is no contractual obligation to transfer cash or other financial assets or issue a variable number of our own equity instruments.

ad *Assets held for sale*

Assets and liabilities of disposal groups and non-current assets are classified as held for sale ('HFS') when their carrying amounts will be recovered principally through sale rather than through continuing use. HFS assets are generally measured at the lower of their carrying amount and fair value less cost to sell.

Immediately before the initial classification as held for sale, the carrying amounts of the relevant assets and liabilities are measured in accordance with applicable HKFRSs. On subsequent remeasurement of a disposal group, fair value less costs to sell of the disposal group is determined after each HFS asset is individually measured under applicable HKFRSs.

4 Operating profit

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

a *Interest income*

	2015 HK$m	2014 HK$m
Total interest income	**132,497**	136,434
Less: interest income classified as 'Net trading income' (note 4(d))	**(8,419)**	(9,617)
Less: interest income classified as 'Net income from financial instruments designated at fair value'(note 4(e))	**(18)**	(35)
	124,060	126,782

Included in the above is interest income accrued on impaired financial assets of HK$277m (2014: HK$215m).

b *Interest expense*

	2015 HK$m	2014 HK$m
Total interest expense	**33,663**	36,122
Less: interest expense classified as 'Net trading income' (note 4(d))	**(3,980)**	(4,449)
	29,683	31,673

c *Net fee income*

	2015 HK$m	2014 HK$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	**15,862**	15,273
– fee expense	**(1,879)**	(1,821)
	13,983	13,452
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**9,032**	8,626
– fee expense	**(1,005)**	(944)
	8,027	7,682

4 Operating profit *(continued)*

d *Net trading income*

	2015 HK$m	2014 HK$m
Dealing profits	**17,523**	13,674
– Foreign exchange	**14,807**	10,761
– Interest rate	**709**	887
– Debt securities	**473**	1,513
– Equities and other trading	**1,534**	513
Interest on trading assets and liabilities	**4,439**	5,168
– Interest income (note 4(a))	**8,419**	9,617
– Interest expense (note 4(b))	**(3,980)**	(4,449)
Dividend income from trading securities	**1,674**	1,384
– Listed investments	**1,636**	1,359
– Unlisted investments	**38**	25
Loss from hedging activities	**(20)**	(6)
Fair value hedges		
– Net gain on hedged items attributable to the hedged risk	**68**	408
– Net loss on hedging instruments	**(88)**	(419)
Cash flow hedges		
– Net hedging gain	**–**	5
	23,616	20,220

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

	2015 HK$m	2014 HK$m
Income/(expense) on assets designated at fair value which back insurance and investment contracts	**(2,304)**	5,025
Increase in fair value of liabilities to customers under investment contracts	**(374)**	(807)
	(2,678)	4,218
Net change in fair value of other financial assets/liabilities designated at fair value[1]	**100**	(205)
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	**18**	35
	(2,560)	4,048

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 2015, the group recognised a HK$26m gain on changes in the fair value of these instruments arising from changes in own credit risk (2014:HK$35m loss).*

f *Gains less losses from financial investments*

	2015 HK$m	2014 HK$m
Gain on partial disposal of investment in Industrial Bank	**10,636**	–
Gain on sale of investment in Bank of Shanghai	**–**	3,320
Gains on disposal of other available-for-sale securities	**983**	1,288
Impairment of available-for-sale equity investments	**(8)**	(2,219)
	11,611	2,389

There were no gains or losses on the disposal of held-to-maturity investments in the year (2014: nil).

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

g *Dividend income*

	2015 HK$m	2014 HK$m
Listed investments	**133**	1,204
Unlisted investments	**77**	170
	210	1,374

h *Other operating income*

	2015 HK$m	2014 HK$m
Gain on 150th anniversary banknotes issuance	**693**	–
Movement in present value of in-force insurance business	**4,689**	3,581
Gains on investment properties	**480**	670
Gain on disposal of property, plant and equipment and assets held for sale	**134**	61
Gain on disposal of subsidiaries, associates and business portfolios	**23**	104
Rental income from investment properties	**404**	422
Loss on reclassification of Techcom Bank	**–**	(251)
Other	**4,016**	3,915
	10,439	8,502

Other included net gains on loans and receivables of HK$278m (2014: HK$197m). There were no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2014: nil).

i *Loan impairment charges and other credit risk provisions*

	2015 HK$m	2014 HK$m
Individually assessed impairment charges:		
– New charges	**4,011**	4,202
– Releases	**(1,390)**	(1,420)
– Recoveries	**(305)**	(156)
	2,316	2,626
Collectively assessed impairment charges	**2,656**	2,272
Other credit risk provisions	**102**	27
Loan impairment charges and other credit risk provisions	**5,074**	4,925

There were no impairment charges against available-for-sale debt securities included in other credit risk provisions (2014: nil). There were no impairment charges or provisions relating to held-to-maturity investments (2014: nil).

4 Operating profit *(continued)*

j *General and administrative expenses*

	2015 HK$m	2014 HK$m
Premises and equipment		
– Rental expenses	**3,542**	3,564
– Other premises and equipment expenses	**4,032**	4,143
	7,574	7,707
Marketing and advertising expenses	**3,900**	3,983
Other administrative expenses	**18,409**	16,588
	29,883	28,278

Included in operating expenses were direct operating expenses of HK$22m (2014: HK$24m) 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 (2014: HK$4m).

Included in operating expenses were minimum lease payments under operating leases of HK$3,692m (2014: HK$3,553m).

k *Auditors' remuneration*

Auditors' remuneration amounted to HK$78m (2014: HK$73m).

5 Insurance income

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

a *Insurance income*

	2015 HK$m	2014 HK$m
Net interest income	**10,486**	9,439
Net fee income	**1,941**	2,083
Net trading loss	**(656)**	(512)
Net income/(loss) from financial instruments designated at fair value	**(2,783)**	4,159
Net insurance premium income (note 5(b))	**52,593**	57,307
Movement in present value of in-force business	**4,689**	3,581
Other operating income	**760**	173
	67,030	76,230
Net insurance claims and benefits paid and movement in liabilities to policyholders (note 5(c))	**(52,431)**	(60,182)
Net operating income	**14,599**	16,048

Notes on the Financial Statements (continued)

5 Insurance income *(continued)*

b *Net insurance premium income*

	Non-linked insurance HK$m	Linked insurance HK$m	Total HK$m
2015			
Gross insurance premium income	**51,367**	**4,937**	**56,304**
Reinsurers' share of gross insurance premium income	**(3,684)**	**(27)**	**(3,711)**
Net insurance premium income	**47,683**	**4,910**	**52,593**
2014			
Gross insurance premium income	50,882	8,271	59,153
Reinsurers' share of gross insurance premium income	(1,831)	(15)	(1,846)
Net insurance premium income	49,051	8,256	57,307

c *Net insurance claims and benefits paid and movement in liabilities to policyholders*

	Non-linked insurance HK$m	Linked insurance HK$m	Total HK$m
2015			
Gross claims and benefits paid and movement in liabilities to policyholders	**53,950**	**1,577**	**55,527**
Claims, benefits and surrenders paid	**21,216**	**3,285**	**24,501**
Movement in provision	**32,734**	**(1,708)**	**31,026**
Reinsurers' share of claims and benefits paid and movement in liabilities to policyholders	**(3,214)**	**118**	**(3,096)**
Reinsurers' share of claims, benefits and surrenders paid	**(318)**	**(445)**	**(763)**
Reinsurers' share of movement in provision	**(2,896)**	**563**	**(2,333)**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**50,736**	**1,695**	**52,431**
2014			
Gross claims and benefits paid and movement in liabilities to policyholders	53,104	8,339	61,443
Claims, benefits and surrenders paid	23,761	2,921	26,682
Movement in provision	29,343	5,418	34,761
Reinsurers' share of claims and benefits paid and movement in liabilities to policyholders	(1,611)	350	(1,261)
Reinsurers' share of claims, benefits and surrenders paid	(204)	(644)	(848)
Reinsurers' share of movement in provision	(1,407)	994	(413)
Net insurance claims and benefits paid and movement in liabilities to policyholders	51,493	8,689	60,182

6 Employee compensation and benefits

a *Employee compensation and benefits*

	2015 HK$m	2014 HK$m
Wages and salaries	**37,846**	35,476
Social security costs	**1,080**	1,046
Retirement benefit costs		
– Defined contribution plans	**1,449**	1,350
– Defined benefit plans (note 6(c)(i))	**751**	1,022
	41,126	38,894

b *Directors' emoluments*

The aggregate emoluments of the Directors of the Bank disclosed pursuant to section 4 of the Companies (Disclosure of Information about Benefits of Directors) Regulation were HK$100m (2014: HK$101m). This comprises fees of HK$9m (2014: HK$9m) and other emoluments of HK$91m (2014: HK$92m) which includes contributions to pension schemes of HK$1m (2014: HK$1m). Non-cash benefits which are included in other emoluments mainly relate to share-based payment awards, and the provision of housing and furnishing.

c *Retirement benefit pension plans*

The group operates a number of retirement benefit plans, with a total cost of HK$2,200m (2014: HK$2,372m), the largest of which is the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme ('the Principal Plan').

In Hong Kong, the Principal Plan covers employees of the Bank and certain other local employees of the Group. The Principal Plan 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, and the group has been moving to defined contribution plans for all new employees. Since the defined benefit element of the Principal Plan is a final salary lump sum scheme, its exposure to longevity risk and interest rate risk is limited.

The trustee assumes the overall responsibility for the Principal Plan but a management committee and a number of sub-committees have also been established. These committees have been established to broaden the governance and manage the concomitant issues. The finance and investment sub-committee manages the various issues in relation to both assets and liabilities of the Principal Plan.

The Principal Plan is predominantly a funded plan with assets which are held in trust funds separate from the group. The actuarial funding valuation of the Principal Plan is reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the defined benefit obligations of the Principal Plan vary according to the economic conditions.

The Principal Plan mainly invests in bonds with a smaller portion in equities and each investment manager has been assigned a benchmark applicable to their respective asset class. The target asset allocations for the portfolio are as follows: Bonds 65% and Equity 35%.

(i) Total defined benefit expense recognised in the income statement

Included within 'Employee compensation and benefits' are components of the expense related to the group's defined benefit pension plans, as follows:

	2015 HK$m	2014 HK$m
Defined benefit pension plan		
Current service cost	**883**	903
Net interest cost on the net defined benefit liability/asset	**132**	120
Past service cost and gains on settlements	**(269)**	(6)
Administrative costs and taxes paid by plan	**5**	5
Total expense (note 6(a))	**751**	1,022

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

(ii) Cumulative actuarial losses recognised in other comprehensive income in respect of defined benefit plans

	2015 HK$m	2014 HK$m
At 1 January	(7,641)	(6,937)
Actuarial losses recognised in other comprehensive income	(662)	(704)
At 31 December	(8,303)	(7,641)

(iii) Net asset/(liability) under defined benefit pension plans

	Fair value of plan assets HK$m	Present value of defined benefit obligations HK$m	Effect of the asset ceiling HK$m	Net defined benefit liability HK$m
Net defined benefit liability				
At 1 January 2015	14,870	(20,356)	(1)	(5,487)
Current service cost	–	(883)	–	(883)
Past service cost and gains from settlements[1]	–	274	–	274
Service cost	–	(609)	–	(609)
Net interest income/(cost) on the net defined benefit liability	297	(429)	–	(132)
Remeasurement effects recognised in other comprehensive income	(548)	(114)	–	(662)
– Return on plan assets (excluding interest income)	(548)	–	–	(548)
– Actuarial gains from changes in demographic assumptions	–	6	–	6
– Actuarial losses from changes in financial assumptions	–	(182)	–	(182)
– Actuarial gains from experience	–	62	–	62
Exchange differences and other movements	(26)	118	–	92
Contributions by the group	983	–	–	983
Contributions by employees	2	(2)	–	–
Benefits paid	(1,604)	1,657	–	53
At 31 December 2015	13,974	(19,735)	(1)	(5,762)
Retirement benefit liabilities recognised on the balance sheet				(5,809)
Retirement benefit assets recognised on the balance sheet (within 'Other assets')				47
Present value of defined benefit obligation relating to:				
– Actives		(19,474)		
– Pensioners		(261)		

6 Employee compensation and benefits *(continued)*

	Fair value of plan assets HK$m	Present value of defined benefit obligations HK$m	Effect of the asset ceiling HK$m	Net defined benefit liability HK$m
Net defined benefit liability				
At 1 January 2014	14,505	(19,207)	(1)	(4,703)
Current service cost	–	(903)	–	(903)
Past service cost and gains from settlements[1]	–	6	–	6
Service cost	–	(897)	–	(897)
Net interest income/(cost) on the net defined benefit liability	345	(465)	–	(120)
Remeasurement effects recognised in other comprehensive income	319	(1,023)	–	(704)
– Return on plan assets (excluding interest income)	319	–	–	319
– Actuarial losses from changes in demographic assumptions	–	(16)	–	(16)
– Actuarial losses from changes in financial assumptions	–	(634)	–	(634)
– Actuarial losses from experience	–	(373)	–	(373)
Exchange differences and other movements	(31)	68	–	37
Contributions by the group	835	–	–	835
Contributions by employees	2	(2)	–	–
Benefits paid	(1,105)	1,170	–	65
At 31 December 2014	14,870	(20,356)	(1)	(5,487)
Retirement benefit liabilities recognised on the balance sheet				(5,606)
Retirement benefit assets recognised on the balance sheet (within 'Other assets')				119
Present value of defined benefit obligation relating to:				
– Actives		(20,115)		
– Deferreds		(4)		
– Pensioners		(237)		

1 *Gains from settlements arise as the difference between assets distributed and liabilities extinguished on settlements.*

The group expects to make HK$1,781m of contributions to defined benefit pension plans during 2016.

(iv) Fair value of plan assets by asset classes

	2015			2014		
	Value HK$m	**Quoted market price in active market HK$m**	**Thereof HSBC HK$m**	Value HK$m	Quoted market price in active market HK$m	Thereof HSBC HK$m
Fair value of plan assets	**13,974**	**13,974**	**407**	14,870	14,870	257
– Equities	**5,233**	**5,233**	**10**	5,251	5,251	81
– Bonds	**7,439**	**7,439**	–	8,328	8,328	–
– Derivatives	–	–	–	1	1	–
– Other[1]	**1,302**	**1,302**	**397**	1,290	1,290	176

1 *Other mainly consists of cash and deposits.*

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

(v) Benefits expected to be paid from the Principal Plan

Benefits expected to be paid from the Principal Plan to retirees over each of the next five years, and in aggregate for the five years thereafter, are as follows:

	2016 HK$m	2017 HK$m	2018 HK$m	2019 HK$m	2020 HK$m	2021-2025 HK$m
HSBC Group Hong Kong Local Staff Retirement Benefit Scheme	**516**	**727**	**804**	**968**	**1,100**	**5,322**

(vi) The Principal Plan's principal actuarial financial assumptions

The present value of the Principal Plan's obligation was HK$12,071m (2014: HK$11,534m). The principal actuarial assumptions used to calculate the group's obligations for the Principal Plan for the year, and used as the basis for measuring the expenses in relation to the Principal Plan, were as follows:

	2015 % p.a.	2014 % p.a.
Discount rate	**1.70**	1.75
Rate of pay increase	**4.0**	4.0
Mortality table	**HKLT2011**[1]	HKLT2011[1]

1 *HKLT2011- Hong Kong Life Tables 2011.*

The group determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations. In countries where there is not a deep market in corporate bonds, government bond yields have been used, and this is the case for the Principal Plan in Hong Kong.

(vii) Actuarial assumption sensitivities

The discount rate and rate of pay increase are sensitive to changes in market conditions arising during the reporting period. The following table shows the effect of changes in these on the Principal Plan:

The effect of changes in key assumptions on the Principal Plan

	HSBC Group Hong Kong Local Staff Retirement Benefit Scheme	
	2015 HK$m	2014 HK$m
Discount rate		
– Change in pension obligation at year end from a 25bps increase	**(249)**	(234)
– Change in pension obligation at year end from a 25bps decrease	**258**	242
– Change in 2015/2014 pension cost from a 25bps increase	**(11)**	(11)
– Change in 2015/2014 pension cost from a 25bps decrease	**11**	11
Rate of pay increase		
– Change in pension obligation at year end from a 25bps increase	**239**	227
– Change in pension obligation at year end from a 25bps decrease	**(233)**	(221)
– Change in 2015/2014 pension cost from a 25bps increase	**11**	10
– Change in 2015/2014 pension cost from a 25bps decrease	**(10)**	(10)

6 Employee compensation and benefits *(continued)*

(viii)Actuarial funding valuation

The latest actuarial funding valuation of the Principal Plan as at 31 December 2012 was issued on 25 June 2013 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$8,428m. On an on-going basis, the value of the Principal Plan's assets represented 99.9% of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries. On a wind-up basis, the Principal Plan's assets represents 107% of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK$527m. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 5% per annum and long-term salary increases of 4% per annum. The recommended employer contribution rate as a percentage of scheme salaries is 16.1% (local staff category) and 20% (senior staff category) for 2014 and 2015. No additional special contributions have been recommended.

The determinations for actuarial funding valuation purposes are based on different methods and assumptions from those used for financial reporting purposes, and as a result should neither be compared nor related to other determinations included in these financial statements.

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% (2014: 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 2015. Deferred taxation is provided for in accordance with the group's accounting policy in note 3(r).

The charge for taxation in the income statement comprises:

	2015 **HK$m**	2014 HK$m
Current income tax		
– Hong Kong taxation – on current year profit	**10,005**	9,039
– Hong Kong taxation – adjustments in respect of prior years	**(134)**	(177)
– Overseas taxation – on current year profit	**8,072**	8,542
– Overseas taxation – adjustments in respect of prior years	**223**	154
	18,166	17,558
Deferred tax		
– Origination and reversal of temporary differences	**(769)**	1,462
– Effect of changes in tax rates	**18**	19
– Adjustments in respect of prior years	**(119)**	(27)
	(870)	1,454
	17,296	19,012

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

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2015							
At 1 January	**106**	**–**	**613**	**229**	**(275)**	**763**	**1,436**
Exchange and other adjustments	**17**	**–**	**(40)**	**253**	**(388)**	**(4)**	**(162)**
Credit/(charge) to income statement	**9**	**–**	**(25)**	**625**	**5**	**(144)**	**470**
Credit/(charge) to reserves	**–**	**–**	**–**	**–**	**(11)**	**103**	**92**
At 31 December	**132**	**–**	**548**	**1,107**	**(669)**	**718**	**1,836**
2014							
At 1 January	154	–	852	669	(743)	1,362	2,294
Exchange and other adjustments	(49)	–	(245)	(8)	490	(142)	46
Credit/(charge) to income statement	1	–	6	(432)	4	(87)	(508)
Charge to reserves	–	–	–	–	(26)	(370)	(396)
At 31 December	106	–	613	229	(275)	763	1,436

(ii) Deferred tax liabilities

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2015							
At 1 January	**736**	**5,390**	**(466)**	**(55)**	**11,453**	**1,528**	**18,586**
Exchange and other adjustments	**24**	**(33)**	**54**	**274**	**(460)**	**(34)**	**(175)**
Charge/(credit) to income statement	**(117)**	**777**	**(23)**	**30**	**(249)**	**(818)**	**(400)**
Charge/(credit) to reserves	**–**	**–**	**–**	**–**	**1,090**	**(302)**	**788**
At 31 December	**643**	**6,134**	**(435)**	**249**	**11,834**	**374**	**18,799**
2014							
At 1 January	568	4,796	(314)	(43)	10,549	495	16,051
Exchange and other adjustments	(36)	(1)	(177)	2	441	(145)	84
Charge/(credit) to income statement	204	595	25	(14)	(242)	378	946
Charge to reserves	–	–	–	–	705	800	1,505
At 31 December	736	5,390	(466)	(55)	11,453	1,528	18,586

7 Tax expense *(continued)*

(iii) Net deferred tax liabilities

	2015 HK$m	2014 HK$m
Deferred tax liabilities recognised on the balance sheet	**18,799**	18,586
Deferred tax assets recognised on the balance sheet	**(1,836)**	(1,436)
	16,963	17,150

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK$2,216m (2014: HK$2,617m). Of this amount, HK$1,988m (2014: HK$1,890m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK$721m (2014: HK$732m) has been provided in respect of distributable reserves or post-acquisition reserves of associates that, on distribution or sale, would attract withholding tax.

Deferred tax is not recognised in respect of the group's investments in subsidiaries and branches where remittance or other realisation is not probable, and for those associates and interests in joint ventures where it has been determined that no additional tax will arise.

c *Provisions for taxation*

	2015 HK$m	2014 HK$m
Current tax liabilities	**2,456**	2,927
Deferred tax liabilities	**18,799**	18,586
	21,255	21,513

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

	2015 HK$m	2014 HK$m
Profit before tax	**117,279**	111,189
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**21,983**	21,184
Adjustments in respect of prior years	**(29)**	(50)
Deferred tax temporary differences previously not recognised	**(35)**	(15)
Effects of profits in associates and joint ventures	**(2,612)**	(2,586)
Non taxable income and gains	**(3,994)**	(2,980)
Permanent disallowables	**887**	1,653
Change in tax rates	**18**	19
Local taxes and overseas withholding taxes	**1,118**	1,267
Others	**(40)**	520
	17,296	19,012

Notes on the Financial Statements (continued)

8 Dividends

Dividends to ordinary shareholders of the parent company

	2015		2014	
	Per share HK$	**Total HK$m**	Per share HK$	Total HK$m
Ordinary dividends paid				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	**0.37**	**14,250**	0.44	15,000
– first interim dividend paid	**0.20**	**7,500**	0.27	9,250
– second interim dividend paid	**0.20**	**7,500**	0.24	9,250
– third interim dividend paid	**0.20**	**7,500**	0.24	9,250
	0.97	**36,750**	1.19	42,750

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2015 of HK$17,065m (HK$0.44 per ordinary share).

Distributions on other equity instruments

	2015 HK$m	2014 HK$m
US$1,900m floating rate perpetual subordinated loans (interest rate at one year US dollar LIBOR plus 3.84%.)	**655**	–

9 Cash and sight balances at central banks

	2015 HK$m	2014 HK$m
Cash in hand	**15,844**	16,223
Sight balances at central banks	**135,259**	140,252
	151,103	156,475

At 31 December 2015, the total amount placed with central banks by the group, included within cash and sight balances at central banks, reverse repurchase agreements - non-trading, and placings with and advances to banks, amounted to HK$290,052m (2014: HK$277,377m).

10 Hong Kong Government certificates of indebtedness

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.

11 Trading assets

	2015 HK$m	2014 HK$m
Debt securities	**178,358**	231,734
Equity shares	**44,775**	41,180
Treasury and other eligible bills	**43,607**	102,028
Other	**35,886**	32,084
	302,626	407,026
Trading assets		
– which may be repledged or resold by counterparties	**718**	4,718
– not subject to repledge or resale by counterparties	**301,908**	402,308
	302,626	407,026

The amount of listed treasury and other eligible bills amounted to HK$2,164m as at 31 December 2015 (2014: HK$8,421m). 'Other' trading assets primarily include settlement accounts with banks and customers.

a *Debt securities*

	2015 HK$m	2014 HK$m
Listed		
– listed in Hong Kong	**30,455**	25,104
– listed outside Hong Kong	**92,479**	134,650
	122,934	159,754
Unlisted	**55,424**	71,980
	178,358	231,734
Issued by public bodies		
– central governments and central banks	**124,962**	163,680
– other public sector entities	**8,115**	8,551
	133,077	172,231
Issued by		
– banks	**22,095**	26,745
– corporate entities	**23,186**	32,758
	178,358	231,734

b *Equity shares*

	2015 HK$m	2014 HK$m
Listed		
– listed in Hong Kong	**15,509**	22,807
– listed outside Hong Kong	**28,584**	17,600
	44,093	40,407
Unlisted	**682**	773
	44,775	41,180
Issued by		
– banks	**5,806**	10,346
– corporate entities	**38,969**	30,834
	44,775	41,180

12 Derivatives

Derivatives are financial instruments that derive their value from the price of underlying items 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 48.

Derivative assets and liabilities are only offset and reported net in the balance sheet when there is a legally enforceable right to offset 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(k).

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. Derivatives (except for derivatives which are designated as effective hedging instruments) are held for trading. Within the held for trading classification are two types of derivative instruments: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second 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. When entering into derivative transactions, the group employs the same credit risk management framework to assess and approve potential credit exposures that it uses for traditional lending.

12 Derivatives *(continued)*

Contract amounts and fair values of assets and liabilities by class of derivatives

The notional contract amounts of derivatives held for trading purposes indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

	2015			2014		
	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	**16,125,677**	**246,202**	**231,885**	14,880,218	221,590	203,420
– spot, forward and future	**11,665,620**	**122,743**	**117,563**	10,060,892	112,297	104,108
– swaps	**3,392,883**	**109,227**	**99,997**	3,422,916	96,769	86,955
– options purchased	**515,299**	**14,054**	**131**	684,251	11,693	416
– options written	**551,875**	**178**	**14,194**	712,159	831	11,941
Interest rate contracts	**15,974,328**	**136,697**	**135,827**	18,254,624	164,071	161,746
– forward and future	**1,146,748**	**183**	**244**	448,799	41	39
– swaps	**14,514,463**	**133,907**	**132,784**	17,593,936	160,827	158,539
– options purchased	**54,662**	**1,226**	**48**	77,354	1,677	205
– options written	**52,728**	**70**	**1,832**	70,790	71	2,137
– other	**205,727**	**1,311**	**919**	63,745	1,455	826
Equity derivatives	**712,028**	**27,815**	**31,330**	1,084,221	37,562	38,247
Credit derivatives	**432,544**	**2,800**	**2,790**	259,298	1,644	1,659
Commodity and other	**95,216**	**5,920**	**5,675**	134,482	5,737	6,211
Total held for trading	**33,339,793**	**419,434**	**407,507**	34,612,843	430,604	411,283
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Interest rate contracts	**7,342**	**60**	**10**	8,140	86	6
	7,342	**60**	**10**	8,140	86	6
Cash flow hedging derivatives						
Exchange rate contracts	**118,323**	**1,511**	**994**	45,047	5,055	595
Interest rate contracts	**66,684**	**171**	**127**	54,040	74	122
	185,007	**1,682**	**1,121**	99,087	5,129	717
Fair value hedging derivatives						
Interest rate contracts	**217,391**	**415**	**1,417**	150,960	297	1,304
Gross total derivatives	**33,749,533**	**421,591**	**410,055**	34,871,030	436,116	413,310
Netting	**–**	**(40,636)**	**(40,636)**	–	(46,182)	(46,182)
Total	**33,749,533**	**380,955**	**369,419**	34,871,030	389,934	367,128

a *Trading derivatives*

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities include market-making and risk management. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume. Risk management activity is undertaken to manage the risk arising from client transactions, with the principal purpose of retaining client margin.

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. Trading derivatives also include derivatives managed in conjunction with financial instruments designated at fair value.

Notes on the Financial Statements (continued)

12 Derivatives *(continued)*

b *Hedging derivatives*

The group uses derivatives (principally interest rate and currency swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall costs to the group of accessing debt capital markets, and to 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.

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

	2015 HK$m	2014 HK$m
Gains/(losses):		
On hedging instruments	**(88)**	(419)
On the hedged items attributable to hedged risk	**68**	408
	(20)	(11)

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and currency swaps that are used to protect against exposures to variability in future interest and principal cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their 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 in other comprehensive income, and accumulated in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

Amount transferred to the income statement in respect of cash flow hedges included a gain of HK$181m (2014: HK$99m loss) taken to "Net interest income" and a gain of HK$1,182m (2014: HK$4,401m gain) taken to "Net trading income". The group does not have any qualifying cash flow hedges that involve non-financial assets or non-financial liabilities (2014: none).

The gains and losses on ineffective portions of such derivatives are recognised immediately in "Net trading income". During the year to 31 December 2015, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2014: insignificant amount).

12 Derivatives *(continued)*

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2015 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 2015			
Cash inflows from assets	**103,693**	**123,920**	**65,679**
Cash outflows from liabilities	**(12,960)**	**(22,468)**	**(11,525)**
Net cash inflows	**90,733**	**101,452**	**54,154**
At 31 December 2014			
Cash inflows from assets	38,841	72,498	48,135
Cash outflows from liabilities	(9,043)	(19,424)	(18,445)
Net cash inflows	29,798	53,074	29,690

c *Unobservable inception profits*

Any initial gain or loss on financial instruments where the valuation is dependent on unobservable parameters is deferred over the life of the contract or until the instrument is redeemed, transferred or sold or the fair value becomes observable. All derivatives that are part of qualifying hedging relationships have valuations based on observable market parameters.

The table below sets out the aggregate unobservable inception profit yet to be recognised in the income statement at the beginning and end of the year with a reconciliation of the changes during the year.

	2015 HK$m	2014 HK$m
Balance at 1 January	**107**	74
Deferrals on new transactions	**371**	331
Reduction due to amortisation	**(171)**	(103)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	**(225)**	(194)
Exchange differences and others	**(3)**	(1)
Balance at 31 December	**79**	107

13 Financial assets designated at fair value

	2015 HK$m	2014 HK$m
Debt securities	**17,755**	17,238
Equity shares	**80,270**	80,957
Treasury and other eligible bills	**1,070**	–
	99,095	98,195

Treasury and other eligible bills are unlisted.

Notes on the Financial Statements (continued)

13 Financial assets designated at fair value *(continued)*

a *Debt securities*

	2015 HK$m	2014 HK$m
Listed		
– listed in Hong Kong	**2,229**	2,388
– listed outside Hong Kong	**7,359**	7,485
	9,588	9,873
Unlisted	**8,167**	7,365
	17,755	17,238
Issued by public bodies		
– central governments and central banks	**646**	1,194
– other public sector entities	**993**	784
	1,639	1,978
Issued by other bodies		
– banks	**8,433**	6,272
– corporate entities	**7,683**	8,988
	17,755	17,238

b *Equity shares*

	2015 HK$m	2014 HK$m
Listed		
– listed in Hong Kong	**6,905**	8,788
– listed outside Hong Kong	**31,221**	37,274
	38,126	46,062
Unlisted	**42,144**	34,895
	80,270	80,957
Issued by		
– banks	**2,501**	3,910
– corporate entities	**77,769**	77,047
	80,270	80,957

14 Non-trading reverse repurchase and repurchase agreements

Non-trading reverse repos and repos with customers and banks are set out below:

	2015 HK$m	2014 HK$m
Assets		
Banks	**168,988**	176,945
Customers	**43,791**	41,956
	212,779	218,901
Liabilities		
Banks	**13,585**	26,751
Customers	**2,573**	1,628
	16,158	28,379

15 Loans and advances to customers

a *Loans and advances to customers*

	2015 HK$m	2014 HK$m
Gross loans and advances to customers	**2,773,819**	2,825,736
Impairment allowances (note 16(a))	**(11,529)**	(10,520)
	2,762,290	2,815,216

b *Analysis of loans and advances to customers based on categories used by the HSBC Group*

The following analysis of loans and advances to customers is based on the categories used by the HSBC Group, including the group, to manage associated risks.

2015	**Hong Kong HK$m**	**Rest of Asia-Pacific HK$m**	**Total HK$m**
Residential mortgages[1]	**472,324**	**260,901**	**733,225**
Credit card advances	**56,791**	**22,180**	**78,971**
Other personal	**132,234**	**84,092**	**216,326**
Total personal	**661,349**	**367,173**	**1,028,522**
Commercial, industrial and international trade	**419,589**	**405,594**	**825,183**
Commercial real estate	**186,463**	**64,420**	**250,883**
Other property-related lending	**207,448**	**65,412**	**272,860**
Government	**6,292**	**2,484**	**8,776**
Other commercial	**133,718**	**145,632**	**279,350**
Total corporate and commercial	**953,510**	**683,542**	**1,637,052**
Non-bank financial institutions	**64,050**	**42,414**	**106,464**
Settlement accounts	**1,099**	**682**	**1,781**
Total financial	**65,149**	**43,096**	**108,245**
Gross loans and advances to customers	**1,680,008**	**1,093,811**	**2,773,819**
Individually assessed impairment allowances	**(2,165)**	**(4,875)**	**(7,040)**
Collectively assessed impairment allowances	**(1,979)**	**(2,510)**	**(4,489)**
Net loans and advances to customers	**1,675,864**	**1,086,426**	**2,762,290**
2014			
Residential mortgages[1]	439,451	283,042	722,493
Credit card advances	54,943	24,863	79,806
Other personal	122,613	79,670	202,283
Total personal	617,007	387,575	1,004,582
Commercial, industrial and international trade	416,759	440,967	857,726
Commercial real estate	201,103	75,631	276,734
Other property-related lending	203,850	62,810	266,660
Government	6,613	2,654	9,267
Other commercial	150,314	151,930	302,244
Total corporate and commercial	978,639	733,992	1,712,631
Non-bank financial institutions	61,264	42,747	104,011
Settlement accounts	3,887	625	4,512
Total financial	65,151	43,372	108,523
Gross loans and advances to customers	1,660,797	1,164,939	2,825,736
Individually assessed impairment allowances	(2,411)	(3,888)	(6,299)
Collectively assessed impairment allowances	(2,103)	(2,118)	(4,221)
Net loans and advances to customers	1,656,283	1,158,933	2,815,216

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$27,702m (2014: HK$26,671m).*

The geographical information shown above has been classified by the location of the principal operations of the subsidiary and by the location of the branch responsible for advancing the funds.

Notes on the Financial Statements (continued)

15 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*

	2015			2014		
	Present value of the minimum lease payments HK$m	**Unearned future finance income HK$m**	**Total minimum lease payments HK$m**	Present value of the minimum lease payments HK$m	Unearned future finance income HK$m	Total minimum lease payments HK$m
Amounts receivable						
– Within one year	**2,494**	**687**	**3,181**	2,756	689	3,445
– After one year but within five years	**8,152**	**1,893**	**10,045**	8,743	2,012	10,755
– After five years	**17,999**	**3,014**	**21,013**	16,663	2,545	19,208
	28,645	**5,594**	**34,239**	28,162	5,246	33,408
Impairment allowances	**(26)**			(43)		
Net investment in finance leases and hire purchase contracts	**28,619**			28,119		

16 Impairment allowances against loans and advances to customers

a *Impairment allowances against loans and advances to customers*

2015	**Individually assessed allowances HK$m**	**Collectively assessed allowances HK$m**	**Total HK$m**
At 1 January	**6,299**	**4,221**	**10,520**
Amounts written off	**(1,505)**	**(3,109)**	**(4,614)**
Recoveries of loans and advances written off in previous years	**305**	**978**	**1,283**
Net charge to income statement (note 4(i))	**2,316**	**2,656**	**4,972**
Unwinding of discount of loan impairment	**(210)**	**(67)**	**(277)**
Exchange and other adjustments	**(165)**	**(190)**	**(355)**
At 31 December (note 15(a))	**7,040**	**4,489**	**11,529**
2014			
At 1 January	5,007	4,494	9,501
Amounts written off	(1,366)	(3,356)	(4,722)
Recoveries of loans and advances written off in previous years	156	1,029	1,185
Net charge to income statement (note 4(i))	2,626	2,272	4,898
Unwinding of discount of loan impairment	(136)	(79)	(215)
Exchange and other adjustments	12	(139)	(127)
At 31 December (note 15(a))	6,299	4,221	10,520

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

b *Impairment allowances on loans and advances to customers*

Impaired loans and advances to customers are those loans and advances where objective evidence exists that full repayment of principal or interest is considered unlikely. Individually assessed allowances are made after taking into account the value of collateral in respect of such loans and advances.

The geographical information shown below has been classified by the location of the principal operations of the subsidiary and by the location of the branch responsible for advancing the funds.

	Hong Kong HK$m	**Rest of Asia-Pacific HK$m**	**Total HK$m**
At 31 December 2015			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	**5,781**	**11,005**	**16,786**
Collectively assessed	**1,674,227**	**1,082,806**	**2,757,033**
– Impaired loans and advances	**728**	**889**	**1,617**
– Non-impaired loans and advances	**1,673,499**	**1,081,917**	**2,755,416**
Total gross loans and advances to customers	**1,680,008**	**1,093,811**	**2,773,819**
Impairment allowances	**(4,144)**	**(7,385)**	**(11,529)**
– Individually assessed	**(2,165)**	**(4,875)**	**(7,040)**
– Collectively assessed	**(1,979)**	**(2,510)**	**(4,489)**
Net loans and advances	**1,675,864**	**1,086,426**	**2,762,290**
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**2,360**	**5,153**	**7,513**
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	**0.3%**	**1.0%**	**0.6%**
Total allowances as a percentage of total gross loans and advances	**0.2%**	**0.7%**	**0.4%**
At 31 December 2014			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	5,297	9,218	14,515
Collectively assessed	1,655,500	1,155,721	2,811,221
– Impaired loans and advances	602	770	1,372
– Non-impaired loans and advances	1,654,898	1,154,951	2,809,849
Total gross loans and advances to customers	1,660,797	1,164,939	2,825,736
Impairment allowances	(4,514)	(6,006)	(10,520)
– Individually assessed	(2,411)	(3,888)	(6,299)
– Collectively assessed	(2,103)	(2,118)	(4,221)
Net loans and advances	1,656,283	1,158,933	2,815,216
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,767	3,373	5,140
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.3%	0.8%	0.5%
Total allowances as a percentage of total gross loans and advances	0.3%	0.5%	0.4%

Notes on the Financial Statements (continued)

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

For individually assessed customer loans and advances where the industry sector comprises not less than 10% of the group's total gross loans and advances to customers, the analysis of gross impaired loans and advances and allowances by major industry sectors based on categories and definitions used by the HSBC Group is as follows:

	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 2015						
Residential mortgages	**733,225**	**1,735**	**(169)**	**(55)**	**24**	**48**
Commercial, industrial and international trade	**825,183**	**8,543**	**(4,513)**	**(2,110)**	**2,084**	**1,155**
Other commercial	**279,350**	**4,133**	**(1,564)**	**(433)**	**555**	**187**
At 31 December 2014						
Residential mortgages	722,493	2,030	(288)	(70)	70	131
Commercial, industrial and international trade	857,726	6,951	(3,820)	(2,182)	1,583	664
Other commercial	302,244	3,756	(1,470)	(211)	800	57

Impairment is assessed collectively to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment or for homogeneous groups of loans that are not considered individually significant.

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

c *Overdue and rescheduled loans and advances to customers*

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%[1]	HK$m	%[1]	HK$m	%[1]
At 31 December 2015						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	**1,081**	**0.1**	**1,712**	**0.2**	**2,793**	**0.1**
– more than six months but less than one year	**1,698**	**0.1**	**1,268**	**0.1**	**2,966**	**0.1**
– more than one year	**2,344**	**0.1**	**2,951**	**0.3**	**5,295**	**0.2**
	5,123	**0.3**	**5,931**	**0.6**	**11,054**	**0.4**
Individually assessed impairment allowances made in respect of amounts overdue	**(1,609)**		**(3,355)**		**(4,964)**	
Fair value of collateral held in respect of amounts overdue	**1,643**		**1,820**		**3,463**	
Rescheduled loans and advances to customers	**409**	**0.0**	**3,134**	**0.3**	**3,543**	**0.1**
At 31 December 2014						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	624	0.0	2,023	0.2	2,647	0.1
– more than six months but less than one year	452	0.0	764	0.1	1,216	0.0
– more than one year	2,024	0.1	2,185	0.2	4,209	0.2
	3,100	0.1	4,972	0.5	8,072	0.3
Individually assessed impairment allowances made in respect of amounts overdue	(1,235)		(2,265)		(3,500)	
Fair value of collateral held in respect of amounts overdue	1,144		1,805		2,949	
Rescheduled loans and advances to customers	431	0.0	2,298	0.2	2,729	0.1

1 *Percentages shown as a proportion of gross loans and advances to customers.*

17 Impairment and rescheduled amounts relating to placings with and advances to banks and other assets

There were no significant impaired or rescheduled placings with and advances to banks, nor overdue or rescheduled other assets as at 31 December 2015 and 31 December 2014. Information relating to overdue balances can be found in the Risk Report.

Notes on the Financial Statements (continued)

18 Financial investments

	2015 HK$m	2014 HK$m
Treasury and other eligible bills		
– available-for-sale	**691,636**	544,536
Debt securities, excluding certificates of deposit		
– held-to-maturity	**215,998**	169,277
– available-for-sale	**710,709**	595,378
Certificates of deposit		
– held-to-maturity	**12,601**	13,349
– available-for-sale	**76,037**	84,822
Equity shares		
– available-for-sale	**9,065**	49,131
	1,716,046	1,456,493
Financial investments		
– which may be repledged or resold by counterparties	**939**	2,091
– not subject to repledge or resale by counterparties	**1,715,107**	1,454,402
	1,716,046	1,456,493

Treasury and other eligible bills are largely unlisted.

a *Held-to-maturity debt securities, including certificates of deposit*

	Book value 2015 HK$m	Book value 2014 HK$m	Fair value 2015 HK$m	Fair value 2014 HK$m
Listed				
– listed in Hong Kong	**11,206**	7,961	**11,507**	8,348
– listed outside Hong Kong	**62,922**	38,870	**64,339**	41,755
	74,128	46,831	**75,846**	50,103
Unlisted	**154,471**	135,795	**160,074**	140,632
	228,599	182,626	**235,920**	190,735
Issued by public bodies				
– central governments and central banks	**5,907**	5,336	**6,584**	6,039
– other public sector entities	**25,676**	17,115	**26,851**	18,067
	31,583	22,451	**33,435**	24,106
Issued by				
– banks	**90,955**	77,303	**93,945**	80,468
– corporate entities	**106,061**	82,872	**108,540**	86,161
	228,599	182,626	**235,920**	190,735

18 Financial Investments *(continued)*

b *Available-for-sale debt securities, including certificates of deposit*

	2015 HK$m	2014 HK$m
Listed		
– listed in Hong Kong	**30,827**	20,774
– listed outside Hong Kong	**517,212**	428,835
	548,039	449,609
Unlisted	**238,707**	230,591
	786,746	680,200
Issued by public bodies		
– central governments and central banks	**574,173**	463,659
– other public sector entities	**72,658**	58,388
	646,831	522,047
Issued by		
– banks	**98,417**	108,692
– corporate entities	**41,498**	49,461
	786,746	680,200

c *Available-for-sale equity shares*

	2015 HK$m	2014 HK$m
Listed		
– listed in Hong Kong	**405**	360
– listed outside Hong Kong	**3,405**	42,736
	3,810	43,096
Unlisted	**5,255**	6,035
	9,065	49,131
Issued by		
– banks	**4,651**	44,167
– corporate entities	**4,414**	4,964
	9,065	49,131

19 Assets transferred, assets charged as security for liabilities, and collateral accepted as security for assets

Financial assets pledged to secure liabilities

	2015 HK$m	2014 HK$m
Treasury bills, debt securities, equities and deposits	**118,762**	119,845

The above table shows assets where a charge has been granted to secure liabilities on a legal and contractual basis.

These transactions are conducted under terms that are usual and customary to collateralised transactions including, where relevant, standard securities lending and repurchase agreements.

Transferred financial assets not qualifying for full derecognition and associated financial liabilities

	2015		2014	
	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	**16,039**	**14,830**	18,194	18,100
Securities lending agreements	**1,658**	**1**	5,165	34
	17,697	**14,831**	23,359	18,134

The financial assets shown above include amounts transferred to third parties that do not qualify for derecognition, notably debt securities held by counterparties as collateral under repurchase agreements and equity securities lent under securities lending agreements. As the substance of these transactions is secured borrowings, the collateral assets continue to be recognised in full and the related liabilities, reflecting the group's obligation to repurchase the transferred assets for a fixed price at a future date, are also recognised on the balance sheet. As a result of these transactions, the group is unable to use, sell or pledge the transferred assets for the duration of the transactions. The group remains exposed to interest rate risk, credit risk and market risk on these pledged instruments. The counterparty's recourse is not limited to the transferred assets.

Collateral accepted as security for assets

	2015 HK$m	2014 HK$m
Fair value of the collateral permitted to sell or repledge in the absence of default	**369,184**	320,998
Fair value of collateral actually sold or repledged	**56,451**	68,146

20 Investments in subsidiaries

The principal subsidiaries of the Bank are:

	Place of incorporation	Principal activity	The group's interest in issued share capital / registered or charter capital
Hang Seng Bank Limited	Hong Kong	Banking	62.14%
HSBC Bank (China) Company Limited	PRC[1]	Banking	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	100%
HSBC Bank Australia Limited[2]	Australia	Banking	100%
HSBC Bank (Taiwan) Limited[2]	Taiwan	Banking	100%
HSBC Life (International) Limited[2]	Bermuda	Retirement benefits and life insurance	100%

1 *People's Republic of China*

2 *Held indirectly*

All the above subsidiaries are included in the group's consolidated financial statements. All these subsidiaries make their financial statements up to 31 December.

The principal places of business are the same as the places of incorporation except for HSBC Life (International) Limited which operates mainly in Hong Kong.

The proportion of voting rights held is the same as the proportion of ownership interest held.

The principal subsidiaries are regulated banking and insurance entities in the Asia-Pacific region 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.

Subsidiary with material non-controlling interest

	2015	2014
Hang Seng Bank Limited		
Ownership interest and voting rights held by non-controlling interests	**37.86%**	37.86%
	HK$m	HK$m
Profit attributable to non-controlling interests	**10,409**	5,730
Accumulated non-controlling interests of the subsidiary	**51,231**	50,057
Dividends paid to non-controlling interests	**4,053**	3,981
Summarised financial information (before intra-group eliminations):		
– Assets	**1,334,429**	1,263,990
– Liabilities	**1,192,448**	1,124,797
– Net operating income before loan impairment	**41,950**	28,570
– Profit for the year	**27,494**	15,131
– Other comprehensive income	**(13,700)**	19,804
– Total comprehensive income	**13,794**	34,935

21 Interests in associates and joint ventures

	2015 HK$m	2014 HK$m
Share of net assets	**118,328**	112,283
Goodwill	**4,042**	4,236
Intangible assets	**123**	194
Deferred tax on intangible assets	**(31)**	(48)
Impairment	**(24)**	(11)
	122,438	116,654

At 31 December 2015, the group's interests in associates amounted to HK$121,929m (2014: HK$116,134m).

Associate

(i) Principal associate

	Place of incorporation	The group's interest in issued share capital
Bank of Communications Co., Ltd.	People's Republic of China	19.03%

Bank of Communications Co., Ltd. is listed on recognised stock exchanges. The fair value represents valuation based on the quoted market price of the shares held (Level 1 in the fair value hierarchy) and amounted to HK$77,039m at 31 December 2015 (2014: HK$101,918m).

Bank of Communications Co., Limited ('BoCom')

The group's investment in BoCom was equity accounted with effect from August 2004. The group's significant influence in BoCom was established as a result of representation on the Board of Directors and, in accordance with the Technical Cooperation and Exchange Programme, the group is assisting in the maintenance of financial and operating policies and a number of staff have been seconded to assist in this process.

Impairment testing

At 31 December 2015, the fair value of the group's investment in BoCom had been below the carrying amount for approximately 44 months, apart from a short period in 2013 and briefly during the first half of 2015. As a result, the group performed an impairment test on the carrying amount of the investment in BoCom. The test confirmed that there was no impairment at 31 December 2015.

	At 31 December 2015			At 31 December 2014		
	VIU HK$bn	Carrying amount HK$bn	Fair value HK$bn	VIU HK$bn	Carrying amount HK$bn	Fair value HK$bn
Bank of Communications Co., Limited	**132.1**	**119.5**	**77.0**	121.7	113.8	101.9

21 Interests in associates and joint ventures *(continued)*

Basis of recoverable amount

The impairment test was performed by comparing the recoverable amount of BoCom, determined by a value in use ('VIU') calculation, with its carrying amount. The VIU calculation used discounted cash flow projections based on management's estimates of earnings. Cash flows beyond the short to medium-term were then extrapolated in perpetuity using a long-term growth rate. An imputed capital maintenance charge ('CMC') is calculated to reflect expected regulatory capital requirements, and is deducted from forecast cash flows. The principal inputs to the CMC calculation include estimates of asset growth, the ratio of risk-weighted assets to total assets, and the expected regulatory capital requirements. Management judgement is required in estimating the future cash flows of BoCom.

Key assumptions in VIU calculation

Long-term growth rate: the growth rate used was 5% (2014: 5%) for periods after 2018 and does not exceed forecast GDP growth in mainland China.

Long-term asset growth rate: the growth rate used was 4% (2014: 4%) for periods after 2018 and this is the rate of growth required for an assumed 5% long-term growth rate in profit.

Discount rate: the discount rate of 13% (2014: 13%) is derived from a range of values obtained by applying a Capital Asset Pricing Model ('CAPM') calculation for BoCom, using market data. Management supplements this by comparing the rates derived from the CAPM with discount rates available from external sources, and the group's discount rate for evaluating investments in mainland China. The discount rate used is within the range of 10.1% to 14.2% (2014: 11.4% to 14.2%) indicated by the CAPM and external sources.

Loan impairment charge as a percentage of customer advances: the ratio used ranges from 0.71% to 0.78% (2014: 0.73% to 1%) in the short to medium-term and are based on the forecasts disclosed by external analysts. For periods after 2018, the ratio is 0.7% (2014: 0.65%), slightly higher than the historical average.

Risk-weighted assets as a percentage of total assets: the ratio used was 67% for all forecast periods (2014: 70% to 72% in the short to medium-term and 70% in the long term). This is consistent with the forecasts disclosed by external analysts.

Cost-income ratio: the ratio used was 41% (2014: ranged from 40.0% to 42.4%) in the short to medium-term. The ratios were consistent with the short to medium-term range forecasts of 40.3% to 40.7% (2014: 37.2% to 44.5%) disclosed by external analysts.

Sensitivity analyses were performed on each key assumption to ascertain the impact of reasonably possible changes in assumptions. The following change to each key assumption used on its own in the VIU calculation would reduce the headroom to nil.

Key assumption	Changes to key assumption to reduce headroom to nil
• Long-term growth rate	• Decrease by 62 basis points
• Long-term asset growth rate	• Increase by 62 basis points
• Discount rate	• Increase by 82 basis points
• Loan impairment charge as a percentage of customer advances	• Increase by 14 basis points
• Risk-weighted assets as a percentage of total assets	• Increase by 466 basis points
• Cost-income ratio	• Increase by 277 basis points

The following table further illustrates the impact on VIU of reasonably possible changes to key assumptions. This reflects the sensitivity of VIU to each key assumption on its own and it is possible that more than one favourable and/or unfavourable change may occur at the same time.

Notes on the Financial Statements (continued)

21 Interests in associates and joint ventures *(continued)*

As at 31 December 2015

HK$bn **Carrying amount: 119.5**	**Favourable change**	**Current model**	**Unfavourable change**
Long-term growth rate	**+100bps**	**5%**	**-210bps**
VIU	**157.2**	**132.1**	**95.6**
Increase/(decrease) in VIU	**25.1**		**(36.5)**
Long-term asset growth rate	**-50bps**	**4%**	**+100bps**
VIU	**141.2**	**132.1**	**110.7**
Increase/(decrease) in VIU	**9.1**		**(21.4)**
Discount rate	**-150bps**	**13%**	**+110bps**
VIU	**164.3**	**132.1**	**115.7**
Increase/(decrease) in VIU	**32.2**		**(16.4)**
Loan impairment charge as a percentage of customer advances	**0.70% throughout**	**2015 to 2018: 0.71% to 0.78%** **2019 onwards: 0.70%**	**2015 to 2018: 0.85%** **2019 onwards: 0.75%**
VIU	**133.2**	**132.1**	**126.8**
Increase/(decrease) in VIU	**1.1**		**(5.3)**
Risk-weighted assets as a percentage of total assets	**-350bps**	**67% throughout**	**+10bps**
VIU	**141.1**	**132.1**	**131.9**
Increase/(decrease) in VIU	**9.0**		**(0.2)**
Cost-income ratio	**-250bps**	**41% throughout**	**+120bps**
VIU	**143.6**	**132.1**	**126.7**
Increase/(decrease) in VIU	**11.5**		**(5.4)**

Based on the forecasts disclosed by external analysts, management estimates that the reasonably possible range of VIU is HK$95.9bn to HK$175.6bn.

As at 31 December 2014

HK$bn `	Favourable change		Current model	Unfavourable change	
Long-term growth rate	+50bp	+100bp	5.00%	-50bp	-100bp
VIU	132.0	143.9	121.7	112.5	104.3
Increase/(decrease) in VIU	10.3	22.2		(9.2)	(17.4)
Discount rate	-50bp	-100bp	13.00%	+50bp	+100bp
VIU	130.2	140.1	121.7	114.2	107.6
Increase/(decrease) in VIU	8.5	18.4		(7.5)	(14.1)
Loan impairment charge as a percentage of customer advances	0.65% throughout		2014 – 2018: 0.73% to 1.00% 2019 onwards: 0.65%	1.00% from 2014 to 2018 2019 onwards: 0.65%	
VIU	125.5		121.7	115.8	
Increase/(decrease) in VIU	3.8			(5.9)	
Risk-weighted assets as a percentage of total assets	-100bp	-200bp	2014 – 2018: 70% to 72% 2019 onwards: 70%	+100bp	+200bp
VIU	123.9	126.4	121.7	119.2	116.8
Increase/(decrease) in VIU	2.2	4.7		(2.5)	(4.9)
Cost-income ratio	-50bp	-100bp	2014 – 2018: 40.0% to 42.4% 2019 onwards: 42.4%	+50bp	+100bp
VIU	124.1	126.7	121.7	119.2	116.8
Increase/(decrease) in VIU	2.4	5.0		(2.5)	(4.9)

21 Interests in associates and joint ventures *(continued)*

Selected financial information of BoCom

The statutory accounting reference date of BoCom is 31 December. For the year ended 31 December 2015, the group included the associate's results on the basis of financial statements made up for the 12 months to 30 September 2015, but taking into account the financial effect of significant transactions or events in the period from 1 October 2015 to 31 December 2015.

	At 30 September 2015 HK$m	At 30 September 2014 HK$m
Selected balance sheet information of BoCom		
Cash and balances at central banks	**1,121,481**	1,165,846
Loans and advances to banks and other financial institutions	**859,625**	620,206
Loans and advances to customers	**4,344,068**	4,248,285
Other financial assets	**1,896,670**	1,387,509
Other assets	**384,827**	353,438
Total assets	**8,606,671**	7,775,284
Deposits by banks and other financial institutions	**2,024,465**	1,628,358
Customer accounts	**5,362,887**	5,148,337
Other financial liabilities	**363,737**	223,852
Other liabilities	**227,311**	196,712
Total liabilities	**7,978,400**	7,197,259
Total equity	**628,271**	578,025
Total equity attributable to:		
– ordinary shareholders	**606,772**	575,424
– non-controlling interests	**3,687**	2,601
– preference shareholders	**17,812**	–
Reconciliation of BoCom's net assets to carrying amount in the group's consolidated financial statements		
The group's share of net assets	**115,497**	109,529
Add: Goodwill	**3,934**	4,122
Add: Intangible assets	**92**	145
Carrying amount	**119,523**	113,796

	For the 12 months ended 30 September	
	2015 HK$m	2014 HK$m
Selected income statement information of BoCom		
Net interest income	**173,631**	170,833
Net fee and commission income	**42,115**	37,157
Loan impairment charges	**(29,245)**	(27,209)
Depreciation and amortisation	**(7,842)**	(7,136)
Tax expense	**(23,073)**	(24,055)
Profit for the year	**82,437**	82,405
Other comprehensive income	**2,919**	1,681
Total comprehensive income	**85,356**	84,086
Dividends received from BoCom	**4,841**	4,629

Notes on the Financial Statements (continued)

21 Interests in associates and joint ventures *(continued)*

(ii) Other associates

Summarised aggregate financial information in respect of associates not individually material

	2015 HK$m	2014 HK$m
Carrying value	**2,407**	2,338
The group's share of:		
– Assets	**2,777**	2,704
– Liabilities	**370**	366
– Profit or loss from continuing operations	**229**	311
– Total comprehensive income	**229**	311
Other expense related to investment in an associate:		
– Impairment of an associate	**24**	11

At 31 December 2015, the group's share of associates' contingent liabilities incurred relating to the group's interest in associates was HK$303,980m (2014: HK$359,524m).

22 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.

	2015 HK$m	2014 HK$m
Goodwill	**6,344**	6,379
Present value of in-force long-term insurance business	**36,897**	32,389
Other intangible assets	**6,327**	6,310
	49,568	45,078

a *Goodwill*

	2015 HK$m	2014 HK$m
Cost at 1 January	**6,379**	6,362
Exchange and other movements	**(35)**	17
Net book value at 31 December	**6,344**	6,379

Segmental analysis of goodwill

	2015 HK$m	2014 HK$m
Hong Kong – Commercial Banking	**24**	24
Hong Kong – Global Banking and Markets	**750**	750
Hong Kong – Private Banking	**82**	82
Rest of Asia-Pacific – Retail Banking and Wealth Management	**1,657**	1,302
Rest of Asia-Pacific – Commercial Banking	**3,018**	3,337
Rest of Asia-Pacific – Global Banking and Markets	**813**	884
Total goodwill in the CGUs listed	**6,344**	6,379

22 Goodwill and intangible assets *(continued)*

During 2015, there was no impairment of goodwill (2014: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs'), determined at 1 July 2015 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 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.

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 2015 were in the range of 8% to 11% across different CGUs. The nominal long-term growth rates used in the impairment test in 2015 for Hong Kong and Rest of Asia-Pacific were 5.9% and 6.8% respectively.

---

b *The present value of in-force long-term insurance business ('PVIF')*

(i) PVIF specific assumptions

The following are the key long term assumptions used in the computation of PVIF for Hong Kong, being the main life insurance operation:

	2015	2014
Weighted average risk free rate	**1.82%**	1.86%
Weighted average risk discount rate	**6.81%**	7.42%
Expenses inflation	**3.00%**	3.00%

(ii) Movement in PVIF for the year ended 31 December

	2015 **HK$m**	2014 HK$m
At 1 January	**32,389**	28,916
Value of new business written during the year	**4,972**	5,317
Movements arising from in-force business:		
– expected return	**(2,518)**	(1,781)
– experience variances	**(136)**	(60)
– changes in operating assumptions	**752**	(731)
Investment return variances	**1,592**	(88)
Changes in investment assumptions	**(9)**	891
Other adjustments	**36**	33
Changes in PVIF	**4,689**	3,581
Exchange differences and other	**(181)**	(108)
At 31 December	**36,897**	32,389

Notes on the Financial Statements (continued)

22 Goodwill and intangible assets *(continued)*

c *Other intangible assets*

	2015			
	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other[1] HK$m**	**Total HK$m**
Cost				
At 1 January	**13,964**	**1,515**	**2,103**	**17,582**
Additions	**1,794**	**–**	**2**	**1,796**
Disposals/amounts written-off	**(345)**	**–**	**(6)**	**(351)**
Exchange and other movements	**(171)**	**(140)**	**(86)**	**(397)**
At 31 December	**15,242**	**1,375**	**2,013**	**18,630**
Accumulated amortisation and impairment				
At 1 January	**10,131**	**1,088**	**53**	**11,272**
Amortisation charge for the year	**1,422**	**91**	**8**	**1,521**
Impairment	**80**	**–**	**1**	**81**
Disposals/amounts written-off	**(342)**	**–**	**(5)**	**(347)**
Exchange and other movements	**(123)**	**(99)**	**(2)**	**(224)**
At 31 December	**11,168**	**1,080**	**55**	**12,303**
Net book value at 31 December	**4,074**	**295**	**1,958**	**6,327**

	2014			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other[1] HK$m	Total HK$m
Cost				
At 1 January	12,645	1,606	2,288	16,539
Additions	1,546	–	–	1,546
Disposals/amounts written-off	(161)	–	(63)	(224)
Exchange and other movements	(66)	(91)	(122)	(279)
At 31 December	13,964	1,515	2,103	17,582
Accumulated amortisation and impairment				
At 1 January	8,818	1,033	84	9,935
Amortisation charge for the year	1,483	120	11	1,614
Impairment	36	–	21	57
Disposals/amounts written-off	(156)	–	(63)	(219)
Exchange and other movements	(50)	(65)	–	(115)
At 31 December	10,131	1,088	53	11,272
Net book value at 31 December	3,833	427	2,050	6,310

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 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

22 Goodwill and intangible assets *(continued)*

An impairment test was carried out in respect of the operating licenses in Taiwan as at 31 December 2015. The result confirmed that there was no impairment. The impairment test was performed by comparing the recoverable amount of the relevant cash generating unit ('CGU'), determined by a value in use calculation, with the carrying amount of the CGU. 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.

Two key assumptions upon which management has based its determination of the recoverable amount of the CGU are the discount rate and the long-term growth rate. The discount rate used during 2015 was 9%. The long-term growth rate used during 2015 was 3%.

23 Property, plant and equipment

a *Property, plant and equipment*

	2015			2014		
	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	**86,753**	**12,784**	**23,826**	85,306	11,392	22,686
Exchange and other adjustments	**(580)**	**(16)**	**(581)**	(366)	1	(290)
Additions	**554**	**699**	**2,434**	376	–	2,488
Disposals	**(28)**	–	**(1,091)**	(14)	–	(1,057)
Elimination of accumulated depreciation on revalued land and buildings	**(2,428)**	–	–	(2,300)	–	–
Surplus on revaluation	**6,601**	**480**	–	4,511	670	–
Reclassifications	**3,128**	**(3,231)**	**(49)**	(760)	721	(1)
At 31 December	**94,000**	**10,716**	**24,539**	86,753	12,784	23,826
Accumulated depreciation						
At 1 January	**74**	–	**18,610**	91	–	18,053
Exchange and other adjustments	**86**	–	**(452)**	(2)	–	(225)
Charge for the year	**2,456**	–	**1,924**	2,294	–	1,813
Disposals	**(25)**	–	**(1,054)**	(1)	–	(1,030)
Elimination of accumulated depreciation on revalued land and buildings	**(2,428)**	–	–	(2,300)	–	–
Reclassifications	**4**	–	**(4)**	(8)	–	(1)
At 31 December	**167**	–	**19,024**	74	–	18,610
Net book value at 31 December	**93,833**	**10,716**	**5,515**	86,679	12,784	5,216
Total at 31 December			**110,064**			104,679

b *The carrying amount of land and buildings, had they been stated at cost less accumulated depreciation, would have been as follows:*

	2015 HK$m	2014 HK$m
Cost less accumulated depreciation	**22,027**	19,387

Notes on the Financial Statements (continued)

23 Property, plant and equipment *(continued)*

c *Valuation of land and buildings and investment properties*

The group's land and buildings and investment properties were revalued in November 2015 and updated for any material changes at 31 December 2015. 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(p). The resultant values are Level 3 in the fair value hierarchy. There were no transfers in to or out of Level 3 during the year (2014: nil). The fair values for land and buildings are determined by using direct comparison approach which values the properties in their respective existing states and uses, assuming sale with immediate vacant possession and by making reference to comparable sales evidence. The valuations take into account the characteristics of the properties (unobservable inputs) which include the location, size, shape, view, floor level, year of completion and other factors collectively. The premium or discount applied to the characteristics of the properties is within minus 20 percent and plus 20 percent. 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$12,627m (2014: HK$12,368m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK$7,077m (2014: HK$5,181m). Amounts of HK$4,908m (2014: HK$3,292m) and HK$476m (2014: HK$671m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$4,908m (2014: HK$3,292m) is stated after deduction of non-controlling interests of HK$711m (2014: HK$552m) and deferred tax of HK$982m (2014: HK$666m). The amount credited to the income statement comprises the surplus of HK$480m (2014: HK$670m) on revaluation of investment properties, less HK$4m of revaluation deficits that arose when the value of certain properties fell below depreciated historical cost or surrender value, and when premises were newly acquired with revaluation losses (2014: HK$1m surplus).

Land and buildings and investment properties in Hong Kong, Macau and mainland China, representing 96% by value of the group's properties subject to valuation. The valuations were carried out by DTZ Debenham Tie Leung Limited who have recent experience in the location and type of properties and who are members of the Hong Kong Institute of Surveyors. Properties in eleven countries, which represent 4% by value of the group's properties, were valued by different independent professionally qualified valuers.

d *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$404m (2014: HK$422m) was recognised as rental income in the income statement in respect of operating leases.

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

	2015	2014
	HK$m	HK$m
Within one year	**310**	411
After one but within five years	**200**	147
	510	558

24 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:

	2015	2014
	HK$m	HK$m
In Hong Kong:		
Medium-term leaseholds (between ten and fifty years)	**260**	277

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 25).

25 Other assets

	2015 HK$m	2014 HK$m
Current tax assets	**1,013**	2,418
Assets held for sale	**159**	148
Prepayments and accrued income	**3,881**	3,821
Accrued interest receivable	**17,305**	18,370
Acceptances and endorsements	**31,480**	31,200
Bullion	**47,105**	59,401
Other	**33,119**	35,518
	134,062	150,876

Other assets included HK$76,035m (2014: HK$82,000m) of financial assets, the majority of which were measured at amortised cost.

26 Customer accounts

	2015 HK$m	2014 HK$m
Current accounts	**949,169**	919,343
Savings accounts	**2,645,151**	2,379,651
Other deposit accounts	**1,045,756**	1,180,998
	4,640,076	4,479,992

27 Trading liabilities

	2015 HK$m	2014 HK$m
Certificates of deposit in issue	**1,770**	3,470
Other debt securities in issue	**18,387**	19,418
Short positions in securities	**60,488**	66,063
Deposits by banks	**12,504**	6,301
Customer accounts	**98,702**	120,560
	191,851	215,812

Other debt securities in issue comprises of structured notes issued, for which market risks are actively managed as part of trading portfolios.

28 Financial liabilities designated at fair value

	2015 HK$m	2014 HK$m
Deposits by banks	**–**	196
Debt securities in issue	**14,721**	11,973
Liabilities to customers under investment contracts	**36,049**	36,665
	50,770	48,834

At 31 December 2015, the carrying amount of the debt securities in issue was HK$102m higher than the contractual amount at maturity (2014: HK$108m). At 31 December 2015, the accumulated loss in fair value attributable to changes in credit risk for debt securities in issue was HK$26m (2014: HK$60m).

Notes on the Financial Statements (continued)

29 Debt securities in issue

	2015 HK$m	2014 HK$m
Certificates of deposit	**6,181**	7,530
Other debt securities	**34,678**	37,767
	40,859	45,297

30 Other liabilities and provisions

	2015 HK$m	2014 HK$m
Accruals and deferred income	**25,425**	26,435
Provisions for liabilities and charges (note 32)	**1,203**	1,141
Acceptances and endorsements	**31,480**	31,200
Share based payment liability to HSBC Holdings plc	**1,769**	2,186
Other liabilities	**27,043**	26,769
	86,920	87,731

Other liabilities included HK$78,221m (2014: HK$78,498m) of financial liabilities which were measured at amortised cost.

31 Liabilities under insurance contracts

	Gross HK$m	Reinsurers' Share[2] HK$m	Net HK$m
2015			
Non-linked insurance contracts[1]			
At 1 January	**265,743**	**(4,182)**	**261,561**
Benefits paid	**(21,216)**	**318**	**(20,898)**
Increase in liabilities to policyholders	**53,950**	**(3,214)**	**50,736**
Foreign exchange and other movements	**99**	**(73)**	**26**
At 31 December	**298,576**	**(7,151)**	**291,425**
Linked insurance contracts			
At 1 January	**44,439**	**(1,441)**	**42,998**
Benefits paid	**(3,285)**	**445**	**(2,840)**
Increase in liabilities to policyholders	**1,577**	**118**	**1,695**
Foreign exchange and other movements	**(487)**	**(514)**	**(1,001)**
At 31 December	**42,244**	**(1,392)**	**40,852**
Total liabilities to policyholders	**340,820**	**(8,543)**	**332,277**
2014			
Non-linked insurance contracts[1]			
At 1 January	236,911	(2,836)	234,075
Benefits paid	(23,761)	204	(23,557)
Increase in liabilities to policyholders	53,104	(1,611)	51,493
Foreign exchange and other movements	(511)	61	(450)
At 31 December	265,743	(4,182)	261,561
Linked insurance contracts			
At 1 January	39,269	(1,695)	37,574
Benefits paid	(2,921)	644	(2,277)
Increase in liabilities to policyholders	8,339	350	8,689
Foreign exchange and other movements	(248)	(740)	(988)
At 31 December	44,439	(1,441)	42,998
Total liabilities to policyholders	310,182	(5,623)	304,559

1 *Includes liabilities under non-life insurance contracts.*
2 *Amounts recoverable from reinsurance of liabilities under insurance contracts are included in the consolidated balance sheet in 'Other assets'.*

32 Provisions for liabilities and charges

Provisions for liabilities and charges

	2015 HK$m	2014 HK$m
At 1 January	**1,141**	1,723
New provisions/increase in provisions	**1,214**	218
Provisions used	**(313)**	(1,013)
Amounts reversed	**(205)**	(195)
Exchange and other movements	**(634)**	408
At 31 December	**1,203**	1,141

Of which: provisions for restructuring costs

	2015 HK$m	2014 HK$m
At 1 January	**113**	225
New provisions/increase in provisions	**840**	55
Provisions used	**(109)**	(108)
Amounts reversed	**(30)**	(67)
Exchange and other movements	**(13)**	8
At 31 December	**801**	113

Included in the above are amounts of HK$239m (2014: HK$842m) relating to ongoing regulatory investigations. There is inherent uncertainty as to the amounts at which such matters will be settled in future, which could be higher or lower than the amounts provided.

33 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.

		2015 HK$m	2014 HK$m
US$800m	Undated floating rate primary capital notes[1]	**6,204**	9,337
AUD200m	Floating rate subordinated notes due 2020, callable from 2015[2]	**–**	1,271
MYR500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017[3]	**897**	1,108
MYR500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022[4]	**902**	1,116
		8,003	12,832

1 *In December 2015, the group redeemed US$400m undated floating rate primary capital notes at par. In January 2016, the group issued a Notice of Redemption to the holders of another series of US$400m capital notes for redemption on 29 February 2016.*
2 *In November 2015, the group redeemed AUD200m floating rate subordinated notes at par.*
3 *The interest rate on the MYR500m 4.35% callable subordinated bonds due 2022 will increase by 1% from June 2017.*
4 *The interest rate on the MYR500m 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.*
5 *Subordinated liabilities issued to Group entities are not included in the above.*

Notes on the Financial Statements (continued)

34 Preference shares

	2015 **HK$m**	2014 HK$m
Issued and fully paid		
Redeemable preference shares	**8,138**	8,143
Irredeemable preference shares	**28,415**	28,439
	36,553	36,582

1,050m cumulative redeemable preference 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 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share together with the amount equal to any accrued but unpaid dividends. The total number of issued cumulative redeemable preference shares at 31 December 2015 was 1,050m (2014: 1,050m). No cumulative redeemable preference shares were issued during the year (2014: nil). The group plans to redeem 1,050m of the cumulative redeemable preference shares in 2016.

The non-cumulative irredeemable preference shares were issued at the then nominal value, and may be cancelled subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of cancellation, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of cancellation, subject to the Bank having sufficient distributable profits. The number of issued non-cumulative irredeemable preference shares at 31 December 2015 was 3,253m (2014: 3,253m). No non-cumulative irredeemable preference shares were issued during the year (2014: nil).

The cumulative irredeemable preference shares were issued at the then 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. The number of issued cumulative irredeemable preference shares at 31 December 2015 was 400m (2014: 400m). No cumulative irredeemable preference shares were issued during the year (2014: nil). The group plans to cancel 200m of the cumulative irredeemable preference shares in 2016.

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

There was INR870m (2014: INR870m) of authorised preference share capital, comprising 8.7m compulsorily convertible preference shares of INR100 each in the share capital of a subsidiary, HSBC InvestDirect Securities (India) Private Limited ('HSBC InvestDirect'). The convertible preference shares ('CCPS') were issued and fully paid in 2009 at a nominal value of INR100 each. These shares may be converted into fully paid equity shares of HSBC InvestDirect at any time after one year to ten years 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. HSBC InvestDirect did not convert any CCPS during 2015 (2014: nil). The number of issued CCPS at 31 December 2015 was 8.7m (2014: 8.7m). No CCPS were issued during the year (2014: nil).

35 Share capital

Issued and fully paid

	2015 HK$m	2014 HK$m
Ordinary share capital	**96,052**	96,052

	2015 Number	2015 HK$m
Ordinary shares	**38,420,982,901**	**96,052**

The shares have no par value. 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.

36 Other equity instruments

Other equity instruments comprise additional tier 1 capital instruments in issue which are accounted for in equity.

		2015 HK$m	2014 HK$m
US$1,000m	Floating rate perpetual subordinated loan, callable from Dec 2019[1]	**7,756**	7,756
US$900m	Floating rate perpetual subordinated loan, callable from Dec 2019[1]	**6,981**	6,981
		14,737	14,737

1 *Interest rate at one year US dollar LIBOR plus 3.84%.*

The additional tier 1 capital instruments are perpetual subordinated loans on which coupon payments may be cancelled at the sole discretion of the Bank. The subordinated loans will be written down at the point of non-viability on the occurrence of a trigger event as defined in the Banking (Capital) Rules. They rank higher than ordinary shares in the event of a wind-up.

37 Maturity analysis of assets and liabilities

The following is an analysis of assets and liabilities by remaining contractual maturities at the balance sheet date:

2015	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 sight balances at central banks	151,103	–	–	–	–	–	–	–	–	151,103
Items in the course of collection from other banks	–	25,020	–	–	–	–	–	–	–	25,020
Hong Kong Government certificates of indebtedness	220,184	–	–	–	–	–	–	–	–	220,184
Trading assets	–	–	–	–	–	–	–	302,626	–	302,626
Derivatives	–	–	–	–	–	–	–	378,858	2,097	380,955
Financial assets designated at fair value	–	1,313	831	1,785	12,007	2,889	80,270	–	–	99,095
Treasury bills	–	1,070	–	–	–	–	–	–	–	1,070
Debt securities	–	243	831	1,785	12,007	2,889	–	–	–	17,755
Equity shares	–	–	–	–	–	–	80,270	–	–	80,270
Reverse repurchase agreements – non-trading	16,433	146,004	25,677	7,872	16,793	–	–	–	–	212,779
Placings with and advances to banks	83,706	178,741	91,352	33,813	24,052	9,557	–	–	–	421,221
Loans and advances to customers	151,833	348,911	313,640	498,306	770,049	691,080	(11,529)	–	–	2,762,290
Financial investments	–	222,004	410,572	407,780	461,377	205,036	9,277	–	–	1,716,046
Treasury and other eligible bills	–	175,178	341,206	175,252	–	–	–	–	–	691,636
Certificates of deposit	–	7,813	16,232	51,515	10,500	2,578	–	–	–	88,638
Debt securities held to maturity	–	83	2,705	10,960	72,802	129,448	–	–	–	215,998
Debt securities available-for-sale	–	38,930	50,429	170,053	378,075	73,010	212	–	–	710,709
Equity shares available-for-sale	–	–	–	–	–	–	9,065	–	–	9,065
Amounts due from Group companies	36,875	106,912	53,997	11,826	17,484	251	–	17,051	–	244,396
Interests in associates and joint ventures	–	–	–	–	–	–	122,438	–	–	122,438
Goodwill and intangible assets	–	–	–	–	–	–	49,568	–	–	49,568
Property, plant and equipment	–	–	–	–	–	–	110,064	–	–	110,064
Deferred tax assets	–	–	–	–	–	–	1,836	–	–	1,836
Other assets	6,608	21,709	33,569	10,596	10,142	2,496	48,942	–	–	134,062
Total assets	666,742	1,050,614	929,638	971,978	1,311,904	911,309	410,866	698,535	2,097	6,953,683

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

	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
2015										
Liabilities										
Hong Kong currency notes in circulation	220,184	–	–	–	–	–	–	–	–	220,184
Items in the course of transmission to other banks	–	30,753	–	–	–	–	–	–	–	30,753
Repurchase agreements – non-trading	6,385	8,161	1,612	–	–	–	–	–	–	16,158
Deposits by banks	128,554	14,744	1,197	1,400	2,324	75	–	–	–	148,294
Customer accounts	3,642,772	540,729	237,184	189,092	29,705	594	–	–	–	4,640,076
Trading liabilities	–	–	–	–	–	–	–	191,851	–	191,851
Derivatives	–	–	–	–	–	–	–	366,881	2,538	369,419
Financial liabilities designated at fair value	349	–	–	–	14,438	224	35,759	–	–	50,770
Debt securities in issue	7	1,553	3,756	6,765	24,695	4,083	–	–	–	40,859
Retirement benefit liabilities	–	–	–	–	–	–	5,809	–	–	5,809
Amounts due to Group companies	24,180	53,956	1,198	339	43	20,125	–	10,232	–	110,073
Other liabilities and provisions	6,558	24,555	35,813	10,037	3,299	469	6,189	–	–	86,920
Liabilities under insurance contracts	2,236	–	–	–	–	–	338,584	–	–	340,820
Current tax liabilities	39	176	247	1,983	11	–	–	–	–	2,456
Deferred tax liabilities	–	–	–	–	–	–	18,799	–	–	18,799
Subordinated liabilities	–	–	3,104	–	897	902	3,100	–	–	8,003
Preference shares	–	–	9,688	–	–	–	26,865	–	–	36,553
Total liabilities	4,031,264	674,627	293,799	209,616	75,412	26,472	435,105	568,964	2,538	6,317,797

Notes on the Financial Statements (continued)

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

2014	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 sight balances at central banks	156,475	–	–	–	–	–	–	–	–	156,475
Items in the course of collection from other banks	–	21,122	–	–	–	–	–	–	–	21,122
Hong Kong Government certificates of indebtedness	214,654	–	–	–	–	–	–	–	–	214,654
Trading assets	–	–	–	–	–	–	–	407,026	–	407,026
Derivatives	–	–	–	–	–	–	–	384,508	5,426	389,934
Financial assets designated at fair value	–	224	404	2,458	10,230	3,922	80,957	–	–	98,195
Treasury bills	–	–	–	–	–	–	–	–	–	–
Debt securities	–	224	404	2,458	10,230	3,922	–	–	–	17,238
Equity shares	–	–	–	–	–	–	80,957	–	–	80,957
Reverse repurchase agreements – non-trading	17,185	146,739	25,959	6,474	22,544	–	–	–	–	218,901
Placings with and advances to banks	89,234	216,293	107,527	37,885	27,129	10,245	–	–	–	488,313
Loans and advances to customers	149,788	343,242	333,097	533,851	776,135	689,623	(10,520)	–	–	2,815,216
Financial investments	93	161,254	315,078	405,194	358,914	166,412	49,548	–	–	1,456,493
Treasury and other eligible bills	93	117,183	253,137	174,123	–	–	–	–	–	544,536
Certificates of deposit	–	6,028	18,421	56,374	13,762	3,586	–	–	–	98,171
Debt securities held to maturity	–	359	1,436	7,157	64,770	95,555	–	–	–	169,277
Debt securities available-for-sale	–	37,684	42,084	167,540	280,382	67,271	417	–	–	595,378
Equity shares available-for-sale	–	–	–	–	–	–	49,131	–	–	49,131
Amounts due from Group companies	83,035	64,891	28,687	3,193	2,983	305	–	8,600	–	191,694
Interests in associates and joint ventures	–	–	–	–	–	–	116,654	–	–	116,654
Goodwill and intangible assets	–	–	–	–	–	–	45,078	–	–	45,078
Property, plant and equipment	–	–	–	–	–	–	104,679	–	–	104,679
Deferred tax assets	–	–	–	–	–	–	1,436	–	–	1,436
Other assets	11,915	23,568	28,906	15,534	7,357	2,443	61,153	–	–	150,876
Total assets	722,379	977,333	839,658	1,004,589	1,205,292	872,950	448,985	800,134	5,426	6,876,746

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

	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
2014										
Liabilities										
Hong Kong currency notes in circulation	214,654	–	–	–	–	–	–	–	–	214,654
Items in the course of transmission to other banks	–	31,331	–	–	–	–	–	–	–	31,331
Repurchase agreements – non-trading	2,497	25,882	–	–	–	–	–	–	–	28,379
Deposits by banks	168,504	50,624	2,131	1,291	4,023	140	–	–	–	226,713
Customer accounts	3,361,396	575,631	269,802	231,562	41,324	277	–	–	–	4,479,992
Trading liabilities	–	–	–	–	–	–	–	215,812	–	215,812
Derivatives	–	–	–	–	–	–	–	365,107	2,021	367,128
Financial liabilities designated at fair value	190	–	–	195	11,632	251	36,566	–	–	48,834
Debt securities in issue	30	2,055	6,985	3,575	28,968	3,684	–	–	–	45,297
Retirement benefit liabilities	–	–	–	–	–	–	5,606	–	–	5,606
Amounts due to Group companies	35,279	63,853	1,200	539	46	22,264	–	12,633	–	135,814
Other liabilities and provisions	6,150	28,171	27,073	16,003	3,511	544	6,279	–	–	87,731
Liabilities under insurance contracts	1,320	–	–	–	–	–	308,862	–	–	310,182
Current tax liabilities	179	69	202	2,469	8	–	–	–	–	2,927
Deferred tax liabilities	–	–	–	–	–	–	18,586	–	–	18,586
Subordinated liabilities	–	–	–	1,271	1,108	1,116	9,337	–	–	12,832
Preference shares	–	–	–	–	107	8,144	28,331	–	–	36,582
Total liabilities	3,790,199	777,616	307,393	256,905	90,727	36,420	413,567	593,552	2,021	6,268,400

Notes on the Financial Statements (continued)

38 Analysis of cash flows payable under financial liabilities by remaining contractual maturities

	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 2015						
Hong Kong currency notes in circulation	**220,184**	**–**	**–**	**–**	**–**	**220,184**
Items in the course of transmission to other banks	**–**	**30,753**	**–**	**–**	**–**	**30,753**
Repurchase agreements - non-trading	**6,385**	**9,890**	**–**	**–**	**–**	**16,275**
Deposits by banks	**128,562**	**15,950**	**1,410**	**2,343**	**84**	**148,349**
Customer accounts	**3,643,166**	**779,904**	**192,808**	**33,562**	**666**	**4,650,106**
Trading liabilities	**191,851**	**–**	**–**	**–**	**–**	**191,851**
Derivatives	**366,823**	**382**	**929**	**946**	**–**	**369,080**
Financial liabilities designated at fair value	**350**	**58**	**203**	**15,072**	**35,948**	**51,631**
Debt securities in issue	**7**	**5,588**	**7,165**	**26,005**	**4,696**	**43,461**
Amounts due to Group companies	**34,532**	**55,185**	**750**	**2,229**	**22,221**	**114,917**
Other financial liabilities	**7,151**	**54,450**	**8,241**	**1,546**	**441**	**71,829**
Subordinated liabilities	**–**	**3,150**	**73**	**1,152**	**4,224**	**8,599**
Preference shares	**–**	**10,212**	**421**	**2,397**	**32,857**	**45,887**
	4,599,011	**965,522**	**212,000**	**85,252**	**101,137**	**5,962,922**
Loan commitments	**1,605,093**	**508,358**	**12,652**	**5,867**	**22**	**2,131,992**
Financial guarantee and credit risk related guarantee contracts	**63,812**	**–**	**–**	**–**	**–**	**63,812**
	6,267,916	**1,473,880**	**224,652**	**91,119**	**101,159**	**8,158,726**
At 31 December 2014						
Hong Kong currency notes in circulation	214,654	–	–	–	–	214,654
Items in the course of transmission to other banks	–	31,331	–	–	–	31,331
Repurchase agreements - non-trading	2,498	25,916	–	–	–	28,414
Deposits by banks	168,511	52,777	1,302	4,060	159	226,809
Customer accounts	3,361,476	848,561	238,213	45,513	283	4,494,046
Trading liabilities	215,812	–	–	–	–	215,812
Derivatives	365,353	274	450	1,163	104	367,344
Financial liabilities designated at fair value	190	45	362	12,169	36,768	49,534
Debt securities in issue	30	9,293	4,162	30,507	3,967	47,959
Amounts due to Group companies	48,165	65,131	951	2,395	24,436	141,078
Other financial liabilities	5,905	48,917	13,527	1,906	480	70,735
Subordinated liabilities	–	162	1,601	2,794	14,141	18,698
Preference shares	–	475	389	3,457	43,565	47,886
	4,382,594	1,082,882	260,957	103,964	123,903	5,954,300
Loan commitments	1,407,919	464,200	11,361	12,700	62	1,896,242
Financial guarantee and credit risk related guarantee contracts	61,666	–	–	–	–	61,666
	5,852,179	1,547,082	272,318	116,664	123,965	7,912,208

38 Analysis of cash flows payable under financial liabilities by remaining contractual maturities *(continued)*

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 the Risk Report.

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

	2015 HK$m	2014 HK$m
Operating profit	**101,449**	95,514
Net interest income	**(94,377)**	(95,109)
Dividend income	**(210)**	(1,374)
Depreciation and amortisation	**5,982**	5,778
Amortisation of prepaid operating lease payments	**17**	18
Loan impairment charges and other credit risk provisions	**5,074**	4,925
Loans and advances written off net of recoveries	**(3,331)**	(3,537)
Other provisions for liabilities and charges	**1,016**	45
Provisions used	**(313)**	(1,013)
Surplus arising on property revaluation	**–**	(1)
Gains on investment properties	**(480)**	(670)
Gain on disposal of property, plant and equipment and assets held for sale	**(134)**	(61)
Gain on disposal of business portfolios	**(23)**	(104)
Net loss on reclassification of associates	**–**	251
Impairment on interests in associates and joint ventures	**13**	11
Gains less losses from financial investments	**(11,611)**	(2,389)
Share-based payments granted cost free	**1,318**	1,442
Movement in present value of in-force business	**(4,689)**	(3,581)
Interest received	**110,427**	109,364
Interest paid	**(29,689)**	(28,598)
Operating profit before changes in working capital	**80,439**	80,911
Change in treasury bills with original term to maturity of more than three months	**(109,172)**	(24,883)
Change in placings with and advances to banks	**24,012**	15,290
Change in certificates of deposit with original term to maturity of more than three months	**8,559**	(10,446)
Change in repos and reverse repos	**(11,842)**	2,148
Change in trading assets	**94,823**	(89,784)
Change in trading liabilities	**(23,961)**	20,780
Change in derivative assets	**8,979**	(1,207)
Change in derivative liabilities	**2,291**	2,076
Change in financial assets designated as fair value	**170**	(8,049)
Change in financial liabilities designated as fair value	**1,936**	7,119
Change in financial investments held for backing liabilities to long-term policyholders	**(34,655)**	(23,657)
Change in loans and advances to customers	**46,848**	(199,817)
Change in amounts due from Group companies	**(52,702)**	(29,719)
Change in other assets	**9,016**	(22,540)
Change in deposits by banks	**(78,419)**	(4,645)
Change in customer accounts	**160,084**	226,294
Change in amounts due to Group companies	**(23,128)**	38,307
Change in debt securities in issue	**(4,438)**	(7,037)
Change in liabilities under insurance contracts	**30,638**	34,002
Change in other liabilities	**25,015**	43,418
Exchange adjustments	**14,015**	13,219
Cash generated from operations	**168,508**	61,780

Notes on the Financial Statements (continued)

40 Analysis of cash and cash equivalents

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

	2015 HK$m	2014 HK$m
Balance at 1 January	**679,670**	687,596
Net cash inflow before the effect of foreign exchange movements	**5,652**	17,880
Effect of foreign exchange movements	**(26,925)**	(25,806)
Balance at 31 December	**658,397**	679,670

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

	2015 HK$m	2014 HK$m
Cash in hand and sight balances with central banks	**151,103**	156,475
Items in the course of collection from other banks	**25,020**	21,122
Reverse repurchase agreements – non-trading	**124,351**	130,093
Placings with and advances to banks	**279,297**	319,758
Treasury bills	**106,590**	77,667
Certificates of deposit	**2,482**	4,133
Other eligible bills	**307**	1,753
Less: items in the course of transmission to other banks	**(30,753)**	(31,331)
	658,397	679,670

The amount of cash and cash equivalents that are subject to exchange control and regulatory restrictions amounted to HK$151,255m at 31 December 2015 (2014: HK$173,883m).

c *Disposal of business portfolios*

	2015	2014		
	Loan portfolios HK$m	Banking businesses HK$m	Loan portfolios HK$m	Total HK$m
Assets				
Loans and advances to customers	**5,069**	2,179	611	2,790
Other assets	**–**	15	–	15
Total assets excluding cash and cash equivalents	**5,069**	2,194	611	2,805
Liabilities				
Other liabilities and provisions	**–**	38	–	38
Total liabilities	**–**	38	–	38
Aggregate net assets at date of disposal, excluding cash and cash equivalents	**5,069**	2,156	611	2,767
Gain on disposal including costs to sell	**23**	84	20	104
Add back: costs to sell	**–**	11	–	11
Selling price	**5,092**	2,251	631	2,882
Satisfied by				
Total cash consideration	**5,092**	2,251	631	2,882

41 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	2015 HK$m	2014 HK$m
Contingent liabilities and financial guarantee contracts		
Guarantees and irrevocable letters of credit pledged as collateral security	**256,561**	246,332
Other contingent liabilities	**1,371**	1,795
	257,932	248,127
Commitments		
Documentary credits and short-term trade-related transactions	**31,337**	37,874
Forward asset purchases and forward forward deposits placed	**4,821**	1,717
Undrawn formal standby facilities, credit lines and other commitments to lend	**2,095,834**	1,856,651
	2,131,992	1,896,242

The above table discloses the nominal principal amounts of commitments excluding capital commitments, guarantees and other contingent liabilities, which are mainly credit-related instruments including both financial and non-financial guarantees and commitments to extend credit. Contractual amounts represent the amounts at risk should contracts be fully drawn upon and clients default. The amount of the loan commitments shown above reflects, where relevant, the expected level of take-up of pre-approved facilities. 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.

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 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:

	2015 HK$m	2014 HK$m
Guarantees in favour of third parties		
Financial guarantees [1]	**54,228**	54,827
Other guarantees [2]	**180,933**	173,960
	235,161	228,787
Guarantees in favour of other HSBC Group entities	**21,400**	17,545
	256,561	246,332

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 *Other guarantees include re-insurance letters of credit related to particular transactions, trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment, performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees.*

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 annual credit review process.

Notes on the Financial Statements (continued)

42 Capital commitments

	2015 HK$m	2014 HK$m
Expenditure contracted for	**3,354**	4,855

Capital commitments mainly relate to the commitment for purchase of premises.

43 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:

	2015 HK$m	2014 HK$m
Premises		
Amounts payable within		
– one year or less	**2,994**	2,893
– five years or less but over one year	**4,744**	4,345
– over five years	**779**	937
	8,517	8,175
Equipment		
Amounts payable within		
– one year or less	**60**	49
– five years or less but over one year	**114**	21
	174	70

44 Offsetting of financial assets and financial liabilities

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements[1]

	Amounts subject to enforceable netting arrangements								
	Effects of offsetting in the balance sheet			Amounts not set-off in the balance sheet					
	Gross amounts HK$m	Amounts offset HK$m	Amounts reported in the balance sheet HK$m	Financial instruments HK$m	Non-cash collateral HK$m	Cash collateral HK$m	Net amount HK$m	Amounts not subject to enforceable netting arrangements[2] HK$m	Balance sheet total HK$m
At 31 December 2015									
Derivatives	**390,543**	**(40,636)**	**349,907**	**(285,735)**	**(7,835)**	**(23,322)**	**33,015**	**31,048**	**380,955**
Reverse repos, stock borrowing and similar agreements classified as:	**350,318**	**(4,109)**	**346,209**	**–**	**(345,629)**	**(373)**	**207**	**22,254**	**368,463**
– trading assets	**182**	**–**	**182**	**–**	**(177)**	**–**	**5**	**171**	**353**
– non-trading assets	**350,136**	**(4,109)**	**346,027**	**–**	**(345,452)**	**(373)**	**202**	**22,083**	**368,110**
Loans and advances to customers at amortised cost	**15,032**	**(15,032)**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	755,893	**(59,777)**	**696,116**	**(285,735)**	**(353,464)**	**(23,695)**	**33,222**	**53,302**	**749,418**[3]
At 31 December 2014									
Derivatives	398,270	(46,182)	352,088	(284,746)	(11,834)	(25,204)	30,304	37,846	389,934
Reverse repos, stock borrowing and similar agreements classified as:	297,681	–	297,681	–	(297,660)	(12)	9	26,070	323,751
– trading assets	208	–	208	–	(201)	–	7	75	283
– non-trading assets	297,473	–	297,473	–	(297,459)	(12)	2	25,995	323,468
Loans and advances to customers at amortised cost	15,044	(15,044)	–	–	–	–	–	–	–
	710,995	(61,226)	649,769	(284,746)	(309,494)	(25,216)	30,313	63,916	713,685[3]

1 *The disclosure has been enhanced this year to show the amounts not subject to enforceable netting agreements and further analysis of amounts not set-off in the balance sheet. Comparative data have been represented accordingly.*

2 *These exposures continue to be secured by financial collateral, but we may not have sought or been able to obtain a legal opinion evidencing enforceability of the offsetting right.*

3 *Amounts presented in the balance sheet included balances due from Group companies of HK$239,795m (2014: HK$187,985m).*

44 Offsetting of financial assets and financial liabilities *(continued)*

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements[1]

	Amounts subject to enforceable netting arrangements								
	Effects of offsetting in the balance sheet			Amounts not set-off in the balance sheet				Amounts not subject to enforceable netting arrangements[2]	
	Gross amounts HK$m	Amounts offset HK$m	Amounts reported in the balance sheet HK$m	Financial instruments HK$m	Non-cash collateral HK$m	Cash collateral HK$m	Net amount HK$m	HK$m	Balance sheet total HK$m
At 31 December 2015									
Derivatives	**381,116**	**(40,636)**	**340,480**	**(285,735)**	**(3,411)**	**(30,356)**	**20,978**	**28,939**	**369,419**
Repos, stock lending and similar agreements classified as:	**59,083**	**(4,109)**	**54,974**	**–**	**(54,848)**	**(3)**	**123**	**5,628**	**60,602**
– trading liabilities	**501**	**–**	**501**	**–**	**(497)**	**–**	**4**	**–**	**501**
– non-trading liabilities	**58,582**	**(4,109)**	**54,473**	**–**	**(54,351)**	**(3)**	**119**	**5,628**	**60,101**
Customer accounts at amortised cost	**15,032**	**(15,032)**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	455,231	**(59,777)**	**395,454**	**(285,735)**	**(58,259)**	**(30,359)**	**21,101**	**34,567**	**430,021**[3]
At 31 December 2014									
Derivatives	384,993	(46,182)	338,811	(284,630)	(17,989)	(22,527)	13,665	28,317	367,128
Repos, stock lending and similar agreements classified as:	73,010	–	73,010	–	(72,941)	(32)	37	11,068	84,078
– trading liabilities	494	–	494	–	(470)	–	24	–	494
– non-trading liabilities	72,516	–	72,516	–	(72,471)	(32)	13	11,068	83,584
Customer accounts at amortised cost	15,044	(15,044)	–	–	–	–	–	–	–
	473,047	(61,226)	411,821	(284,630)	(90,930)	(22,559)	13,702	39,385	451,206[3]

1 *The disclosure has been enhanced this year to show the amounts not subject to enforceable netting agreements and further analysis of amounts not set-off in the balance sheet. Comparative data have been represented accordingly.*
2 *These exposures continue to be secured by financial collateral, but we may not have sought or been able to obtain a legal opinion evidencing enforceability of the offsetting right.*
3 *Amounts presented in the balance sheet included balances due to Group companies of HK$152,261m (2014: HK$161,910m).*

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

The 'Amounts not set off in the balance sheet' for derivatives and reverse repurchase/ repurchase, stock borrowing/ lending and similar arrangements include transactions where:

- the counterparty has an offsetting exposure with the group and a master netting or similar arrangement is in place with a right of set off only in the event of default, insolvency or bankruptcy, or the offset criteria are otherwise not satisfied; and
- cash and non-cash collaterals are received and pledged in respect of the transactions described above.

45 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 activities 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 offers a broad range of products and services to serve the needs of our commercial customers. These include 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. The client-focused business lines deliver a full range of banking capabilities including financing; advisory and transaction services; a markets business that provides services in credit, rates, foreign exchange, money markets, securities services and principal investment activities; and
- Global Private Banking provides a range of services to meet the banking, investment and wealth advisory needs of high net worth individuals.

Notes on the Financial Statements (continued)

45 Segmental analysis *(continued)*

Total assets

	2015		2014	
	HK$m	%	HK$m	%
Hong Kong	4,934,662	71.0	4,630,716	67.3
Rest of Asia-Pacific	2,588,062	37.2	2,788,418	40.5
Intra region	(569,041)	(8.2)	(542,388)	(7.8)
	6,953,683	100.0	6,876,746	100.0

Total liabilities

	2015		2014	
	HK$m	%	HK$m	%
Hong Kong	4,613,757	73.0	4,325,607	69.0
Rest of Asia-Pacific	2,273,081	36.0	2,485,181	39.7
Intra region	(569,041)	(9.0)	(542,388)	(8.7)
	6,317,797	100.0	6,268,400	100.0

Interests in associates and joint ventures

	2015		2014	
	HK$m	%	HK$m	%
Hong Kong	2,403	2.0	2,316	2.0
Rest of Asia-Pacific	120,035	98.0	114,338	98.0
	122,438	100.0	116,654	100.0

Credit commitments and contingencies (contract amounts)

	2015		2014	
	HK$m	%	HK$m	%
Hong Kong	1,273,983	53.3	1,130,366	52.7
Rest of Asia-Pacific	1,115,941	46.7	1,014,003	47.3
	2,389,924	100.0	2,144,369	100.0

Additions to property, plant and equipment and other intangible assets during the year

	2015		2014	
	HK$m	%	HK$m	%
Hong Kong	4,523	82.5	3,512	79.6
Rest of Asia-Pacific	960	17.5	898	20.4
	5,483	100.0	4,410	100.0

45 Segmental analysis *(continued)*

Consolidated income statement

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2015				
Interest income	**60,096**	**66,923**	**(2,959)**	**124,060**
Interest expense	**(7,436)**	**(25,206)**	**2,959**	**(29,683)**
Net interest income	**52,660**	**41,717**	**–**	**94,377**
Fee income	**37,322**	**15,906**	**(1,302)**	**51,926**
Fee expense	**(5,002)**	**(2,567)**	**1,302**	**(6,267)**
Net trading income	**13,681**	**9,935**	**–**	**23,616**
Net income/(expense) from financial instruments designated at fair value	**(3,220)**	**660**	**–**	**(2,560)**
Gains less losses from financial investments	**11,290**	**321**	**–**	**11,611**
Dividend income	**192**	**18**	**–**	**210**
Net insurance premium income	**45,758**	**6,835**	**–**	**52,593**
Other operating income	**12,992**	**1,433**	**(3,986)**	**10,439**
Total operating income	**165,673**	**74,258**	**(3,986)**	**235,945**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(45,909)**	**(6,522)**	**–**	**(52,431)**
Net operating income before loan impairment charges and other credit risk provisions	**119,764**	**67,736**	**(3,986)**	**183,514**
Loan impairment charges and other credit risk provisions	**(1,199)**	**(3,875)**	**–**	**(5,074)**
Net operating income	**118,565**	**63,861**	**(3,986)**	**178,440**
Operating expenses	**(45,933)**	**(35,044)**	**3,986**	**(76,991)**
Operating profit	**72,632**	**28,817**	**–**	**101,449**
Share of profit in associates and joint ventures	**240**	**15,590**	**–**	**15,830**
Profit before tax	**72,872**	**44,407**	**–**	**117,279**
Tax expense	**(10,146)**	**(7,150)**	**–**	**(17,296)**
Profit for the year	**62,726**	**37,257**	**–**	**99,983**
Profit attributable to shareholders	**52,448**	**37,085**	**–**	**89,533**
Profit attributable to non-controlling interests	**10,278**	**172**	**–**	**10,450**
Net operating income				
– external	**109,739**	**64,981**	**–**	**174,720**
– inter-company/inter-segment	**8,826**	**(1,120)**	**(3,986)**	**3,720**
Depreciation and amortisation included in operating expenses	**(4,827)**	**(1,155)**	**–**	**(5,982)**
Restructuring costs	**(186)**	**(437)**	**–**	**(623)**

Notes on the Financial Statements (continued)

45 Segmental analysis *(continued)*

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2014				
Interest income	57,751	72,841	(3,810)	126,782
Interest expense	(6,977)	(28,508)	3,812	(31,673)
Net interest income	50,774	44,333	2	95,109
Fee income	34,708	17,301	(1,347)	50,662
Fee expense	(4,712)	(2,675)	1,347	(6,040)
Net trading income	11,663	8,559	(2)	20,220
Net income from financial instruments designated at fair value	3,134	914	–	4,048
Gains less losses from financial investments	2,286	103	–	2,389
Dividend income	1,362	12	–	1,374
Net insurance premium income	50,226	7,081	–	57,307
Other operating income	10,872	1,693	(4,063)	8,502
Total operating income	160,313	77,321	(4,063)	233,571
Net insurance claims and benefits paid and movement in liabilities to policyholders	(52,916)	(7,266)	–	(60,182)
Net operating income before loan impairment charges and other credit risk provisions	107,397	70,055	(4,063)	173,389
Loan impairment charges and other credit risk provisions	(2,478)	(2,447)	–	(4,925)
Net operating income	104,919	67,608	(4,063)	168,464
Operating expenses	(42,270)	(34,743)	4,063	(72,950)
Operating profit	62,649	32,865	–	95,514
Share of profit in associates and joint ventures	317	15,358	–	15,675
Profit before tax	62,966	48,223	–	111,189
Tax expense	(10,132)	(8,880)	–	(19,012)
Profit for the year	52,834	39,343	–	92,177
Profit attributable to shareholders	47,228	39,200	–	86,428
Profit attributable to non-controlling interests	5,606	143	–	5,749
Net operating income				
– external	95,906	69,459	–	165,365
– inter-company/inter-segment	9,013	(1,851)	(4,063)	3,099
Depreciation and amortisation included in operating expenses	(4,551)	(1,227)	–	(5,778)
Restructuring costs	(55)	(12)	–	(67)

45 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 2015							
External	**53,684**	**39,965**	**64,563**	**2,871**	**13,637**	**–**	**174,720**
Intercompany/intersegment	**11,309**	**(371)**	**(8,112)**	**1,161**	**6,112**	**(6,379)**	**3,720**
Year ended 31 December 2014							
External	52,725	41,199	65,475	2,735	3,231	–	165,365
Intercompany/intersegment	11,815	(720)	(10,867)	1,190	8,225	(6,544)	3,099

Information by country

	External net operating income[1]		Non-current assets[2]	
	2015 HK$m	2014 HK$m	**2015 HK$m**	2014 HK$m
Hong Kong	**109,739**	95,906	**104,503**	98,056
Mainland China	**16,823**	17,085	**127,346**	121,426
Australia	**6,464**	7,210	**822**	1,034
India	**7,375**	7,815	**2,203**	2,374
Indonesia	**2,382**	3,962	**3,424**	3,869
Malaysia	**6,497**	6,958	**762**	944
Singapore	**9,146**	9,493	**1,412**	1,429
Taiwan	**3,193**	3,597	**2,118**	2,174
Other	**13,101**	13,339	**2,584**	2,716
Total	**174,720**	165,365	**245,174**	234,022

1 *External net 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.*

46 Related party transactions

a *Immediate and ultimate holding company*

The group is wholly-owned by HSBC Asia Holdings B.V.. HSBC Asia Holdings B.V. is in turn wholly-owned by HSBC Asia Holdings (UK) Limited, which is wholly-owned by HSBC Holdings B.V.. HSBC Holdings B.V. is wholly-owned by HSBC Finance (Netherlands), which is wholly-owned by HSBC Holdings plc (incorporated in England).

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for the benefit of the group's employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

Transactions with the immediate holding company during the year included the issuance of subordinated liabilities. Transactions with the ultimate holding company during the year included the redemption of subordinated liabilities.

Notes on the Financial Statements (continued)

46 Related party transactions *(continued)*

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2015	2014	**2015**	2014
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**892**	976	**534**	569
Other operating income	**–**	–	**577**	318
Other operating expenses	**7**	13	**2,433**	2,331

1 *Interest expense represents distribution on preference shares and interest on subordinated liabilities.*

Balances at 31 December

	Immediate holding company		Ultimate holding company	
	2015	2014	**2015**	2014
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Other assets	**–**	–	**102**	30
	–	–	**102**	30
Liabilities				
Other liabilities	**554**	525	**624**	625
Subordinated liabilities	**1,395**	–	**18,679**	22,185
Preference shares	**36,451**	36,474	**–**	–
	38,400	36,999	**19,303**	22,810
Guarantees	**–**	–	**–**	–

b *Share option and share award schemes*

The group participates in various share option and share plans operated by HSBC whereby share options or shares of HSBC are granted to employees of the group. As disclosed in note 47, the group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of share options is treated as a capital contribution and is recorded within 'Other reserves'. In respect of share awards, the group recognises a liability to the ultimate holding company over the vesting period. This liability is measured at the fair value of the shares at each reporting date, with changes since the award dates adjusted through the capital contribution account within 'Other reserves'. The balances of the capital contribution and the liability as at 31 December 2015 amounted to HK$3,483m and HK$1,769m respectively (2014: HK$3,139m and HK$2,186m respectively).

c *Pension funds*

At 31 December 2015, HK$12.6bn (2014: HK$11.2bn) 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$22m for the year (2014: HK$22m).

46 Related party transactions *(continued)*

d *Fellow subsidiaries*

The group entered into transactions with its fellow subsidiaries in the normal course of business, including the acceptance and placement of interbank deposits, correspondent banking transactions and off-balance sheet transactions. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The group shares the costs of certain IT projects with its fellow subsidiaries and also used certain processing services of fellow subsidiaries on a cost recovery basis. The Bank also acted as agent for the distribution of retail investment funds for fellow subsidiaries and paid professional fees for services provided by fellow subsidiaries. The commissions and fees in these transactions and services are priced on an arm's length basis.

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

Income and expenses for the year

	Fellow subsidiaries	
	2015	2014
	HK$m	HK$m
Interest income	**599**	384
Interest expense	**341**	227
Fee income	**2,604**	2,404
Fee expense	**802**	870
Other operating income	**2,729**	2,756
Other operating expenses[1]	**7,586**	6,961

1 *In 2015 payments were made of HK$1,014m (2014: HK$1,002m) for software costs which were capitalised as intangible assets in the balance sheet of the group.*

Balances at 31 December

	Fellow subsidiaries	
	2015	2014
	HK$m	HK$m
Assets		
Trading assets	**17,051**	8,600
Other assets	**227,243**	183,064
	244,294	191,664
Liabilities		
Trading liabilities	**10,232**	12,633
Financial liabilities designated at fair value	**4**	4
Other liabilities	**78,585**	99,842
Preference shares	**102**	108
	88,923	112,587
Guarantees	**21,400**	17,545
Commitments	**2,841**	2,185

Derivative balances

In addition, the group had the following derivative asset and derivative liability balances with other HSBC Group entities:

	2015	2014
	HK$m	HK$m
Derivative assets	**101,630**	98,346
Derivative liabilities	**108,317**	106,704

Notes on the Financial Statements (continued)

46 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 21. Transactions and balances during the year with associates and joint ventures were as follows:

	2015		2014	
	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	32,372	15,614	41,814	32,848
Amounts due from joint ventures				
– unsubordinated	2	–	1	–
	32,374	15,614	41,815	32,848
Amounts due to associates	8,113	713	5,038	1,259
Commitments	1	1	11	1

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 due 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.

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:

	2015 HK$m	2014 HK$m
Salaries and other short term benefits	233	209
Retirement benefits		
– Defined contribution plans	8	5
– Defined benefit plans	5	5
Share-based payments	179	177
	425	396

46 Related party transactions *(continued)*

Transactions, arrangements and agreements involving Key Management Personnel

	2015 HK$m	2014 HK$m
During the year		
Highest average assets[1]	**27,536**	34,385
Highest average liabilities[1]	**39,743**	41,527
Contribution to the group's profit before tax	**865**	1,056
At the year end		
Guarantees	**4,379**	4,809
Commitments	**2,268**	3,483

1 *The disclosure of the highest average balance during the year is considered the most meaningful information to represent transactions during the year.*

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, and 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.

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 (2014: nil).

The group adheres to Hong Kong Banking Ordinance Section 83 regarding disclosure on 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. During 2015, the Bank provided a facility in which a non-executive Director of the Bank had a material interest. Disclosure of this arrangement has been made below, pursuant to Section 22 of the Companies (Disclosure of Information about Benefits of Directors) Regulation.

On 7 January 2015, the Bank provided a HK$45bn bridging loan facility to Cheung Kong Property Holdings Limited ('CKPH') for a term of 364-days. CKPH is an associated body corporate of Mr Victor Li, a non-executive Director of the Bank. The facility was provided on an arm's length basis.

---

g *Loans to directors*

Directors are defined as the Directors of the Bank, its ultimate holding company, HSBC Holdings plc and intermediate companies, as well as companies that are controlled by, and entities that are connected with these directors. Particulars of loans to directors disclosed pursuant to section 17 of the Companies (Disclosure of Information about Benefits of Directors) Regulation are as follows:

	Aggregate amount outstanding at 31 December		Maximum aggregate amount outstanding during the year	
	2015 HK$m	2014 HK$m	2015 HK$m	2014 HK$m
By the Bank	**3,246**	2,722	**4,467**	2,819
By subsidiaries	**–**	–	**1**	1
	3,246	2,722	**4,468**	2,820

These amounts include principal and interest, and the maximum liability that may be incurred under guarantees.

Notes on the Financial Statements (continued)

47 Share-based payments

a *Income statement charge*

	2015 HK$m	2014 HK$m
Restricted share awards	**1,303**	1,398
Savings-related and other share award option plans	**78**	94
	1,381	1,492
Equity-settled share-based payments	**1,318**	1,442
Cash-settled share-based payments	**63**	50

b *HSBC Share Award and Option Plans*

Award	Policy	Purpose
Restricted share awards (including annual incentive awards delivered in shares) and Group Performance Shares Plan (‘GPSP’)	• An assessment of performance over the relevant period ending on 31 December is used to determine the amount of the award to be granted. • Deferred awards generally require employees to remain in employment over the vesting period and are not subject to performance conditions after the grant date. • Deferred share awards generally vest over a period of three years and GPSP awards vest after five years. • Vested shares may be subject to a retention requirement (restriction) post-vesting. GPSP awards are retained until cessation of employment. • Awards granted from 2010 onwards are subject to a malus provision prior to vesting. • Awards granted to Material Risk Takers from 2015 onwards are subject to clawback post vetting.	• To drive and reward performance consistent with strategy and align to shareholder interests. • Deferral provides an incentive for a longer-term commitment and the ability to apply malus.
International Employee Share Purchase Plan (‘ShareMatch’)	• The plan was first introduced in Hong Kong in 2013 and now includes employees based in 12 jurisdictions. • Shares are purchased in the market each quarter up to a maximum value of £250 or the equivalent in local currency. • Matching awards are added at a ratio of one free share for every three purchased. • Matching awards vest subject to continued employment and the retention of the purchased shares for a maximum period of two years and nine months.	• To align the interests of all employees with the creation of shareholder value.
Savings-related share option plan (‘Sharesave’)	• 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. The last grant of options under this plan was in 2012. • Exercisable 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% (2014: 20%) discount to the market value immediately preceding the date of invitation.	• To align the interests of all employees with the creation of shareholder value.
Executive Share Option Scheme (‘ESOS’) and Group Share Option Plan (‘GSOP’)	• Plan ceased in May 2005. • Exercisable between third and tenth anniversaries of the date of grant.	• Long-term incentive plan between 2000 and 2005 during which certain HSBC employees were awarded share options.

Calculation of fair values

The fair values of share options are calculated using a Black-Scholes model. The fair value of a share award is based on the share price at the date of the grant.

47 Share-based payments *(continued)*

c *Movement on HSBC share awards*

	2015 Number (000s)	2014 Number (000s)
Outstanding at 1 January	**28,461**	25,369
Additions during the year	**19,843**	19,177
Released during the year	**(19,444)**	(18,975)
Forfeited during the year	**(1,032)**	2,890
Outstanding at 31 December	**27,828**	28,461
Weighted average fair value of awards granted (HK$)	**75.39**	79.31

d *Movement on HSBC share option plans*

	ESOS and GSOP		Savings-related option scheme	
	Number (000s)	WAEP[1] £	Number (000s)	WAEP[1] HK$
2015				
Outstanding at 1 January	**84**	**7.29**	**8,643**	**55.21**
Granted during the year	–	–	**43**	**48.41**
Exercised during the year	–	–	**(6,115)**	**54.62**
Forfeited/expired during the year	**(84)**	**7.29**	**(588)**	**54.25**
Outstanding at 31 December	–	–	**1,983**	**57.05**
Exercisable at 31 December	–	–	–	–
At 31 December 2015				
Weighted average fair value of options granted during the year		–		**8.39**
Weighted average share price at the date the options were exercised		–		**64.26**
Weighted average remaining contractual life (years)		–		**1.18**
2014				
Outstanding at 1 January	7,258	7.22	29,358	44.47
Granted during the year	–	–	15	66.27
Exercised during the year	(2)	7.22	(19,846)	39.41
Forfeited/expired during the year	(7,172)	7.22	(884)	52.46
Outstanding at 311 December	84	7.29	8,643	54.47
Exercisable at 31 December	84	7.29	861	43.21
At 31 December 2014				
Weighted average fair value of options granted during the year		–		14.81
Weighted average share price at the date the options were exercised		6.13		82.76
Weighted average remaining contractual life (years)		0.30		0.70

1 *Weighted Average Exercise Price.*

During the year, no options were granted for schemes with option prices set in Hong Kong dollars, Euros and US dollars.

The exercise price of the savings-related option schemes are primarily set in Hong Kong dollars and pounds sterling (‘GBP’). The exercise price range for the scheme with price set in HK$ and GBP are HK$37.88 – HK$63.99 (2014: HK$37.88 – HK$63.99) and £3.31 – £5.47 (2014: £3.31 – £5.47) respectively.

Notes on the Financial Statements (continued)

48 Fair values of financial instruments carried at fair value

The accounting policies which determine the classification of financial instruments and the use of assumptions and estimation in valuing them are described in note 2 and note 3 respectively. The fair value of financial instruments is generally measured on the basis of the individual financial instrument. However, in cases where the group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the group measures the fair value of the group of financial instruments on a net basis, but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the HKFRS offsetting criteria as described in note 3(m).

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following table sets out the financial instruments carried at fair value.

Financial instruments carried at fair value and bases of valuation

		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[3] HK$m	Total HK$m
At 31 December 2015						
Assets						
Trading assets[2]	**158,173**	**143,611**	**842**	**302,626**	**–**	**302,626**
Derivatives	**6,914**	**271,230**	**1,181**	**279,325**	**101,630**	**380,955**
Financial assets designated at fair value	**65,883**	**30,766**	**2,446**	**99,095**	**–**	**99,095**
Available-for-sale investments[1]	**1,015,065**	**466,129**	**6,253**	**1,487,447**	**–**	**1,487,447**
Liabilities						
Trading liabilities[2]	**56,291**	**128,102**	**7,458**	**191,851**	**–**	**191,851**
Derivatives	**5,773**	**253,647**	**1,682**	**261,102**	**108,317**	**369,419**
Financial liabilities designated at fair value	**–**	**50,770**	**–**	**50,770**	**–**	**50,770**
At 31 December 2014						
Assets						
Trading assets[2]	210,397	196,464	165	407,026	–	407,026
Derivatives	9,039	281,764	785	291,588	98,346	389,934
Financial assets designated at fair value	73,337	22,947	1,911	98,195	–	98,195
Available-for-sale investments[1]	736,254	530,901	6,712	1,273,867	–	1,273,867
Liabilities						
Trading liabilities[2]	63,614	140,045	12,153	215,812	–	215,812
Derivatives	10,766	248,550	1,108	260,424	106,704	367,128
Financial liabilities designated at fair value	–	48,834	–	48,834	–	48,834

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 18.*
2 *Amounts with HSBC Group entities are not reflected here.*
3 *Derivative balances with HSBC Group entities are largely under 'Level 2'.*

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

48 Fair values of financial instruments carried at fair value *(continued)*

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined, or validated, by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia*:

- the extent to which prices may be expected to represent genuine traded or 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 valuation models, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an on-going basis.

Changes in fair value are generally subject to a profit and loss analysis process. This process disaggregates changes in fair value into three high level categories: (i) portfolio changes, such as new transactions or maturing transactions; (ii) market movements, such as changes in foreign exchange rates or equity prices; and (iii) other, such as changes in fair value adjustments.

To this end, the ultimate responsibility for the determination of fair values lies within the Finance function, which reports 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

Fair values are determined according to the following hierarchy:

(a) Level 1 – Valuation technique using quoted market price

Financial instruments with quoted prices for identical instruments in active markets that the group can access at the measurement date.

(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 valuation techniques where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities used. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and quoted price. In the event that the market for a financial instrument is not active, another valuation technique is used.

48 Fair values of financial instruments carried at fair value *(continued)*

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.

Financial liabilities measured at fair value

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes.

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.

Fair value adjustments

Fair value adjustments are adopted when the group considers that there are additional factors that would be considered relevant by a market participant that are not incorporated within the valuation model. The group classifies fair value adjustments as either ‘risk-related’ or ‘model-related’. The majority of these adjustments relate to 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.

48 Fair values of financial instruments carried at fair value *(continued)*

Risk-related adjustments

(i) Bid-offer

HKFRS 13 requires use of the price within the bid-offer spread that is most representative of fair value. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the extent to which bid-offer costs would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of, or unwinding the position.

(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 more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

(iii)Credit valuation adjustment

The credit valuation adjustment is an adjustment to the valuation of over-the-counter ('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. Further detail is provided below.

(iv)Debit valuation adjustment

The debit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the group may default, and that the group may not pay full market value of the transactions.

(v) Funding fair value adjustment

The funding fair value adjustment is calculated by applying future market funding spreads to the expected future funding exposure of any uncollateralised component of the OTC derivative portfolio. This includes the uncollateralised component of collateralised derivatives in addition to derivatives that are fully uncollateralised. The expected future funding exposure is calculated by a simulation methodology, where available. The expected future funding exposure is adjusted for events that may terminate the exposure such as the default of the group or the counterparty. The funding fair value adjustment and debit valuation adjustment are calculated independently.

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 when 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(i). An analysis of the movement in the deferred Day 1 profit or loss reserve is provided in note 12(c).

Notes on the Financial Statements (continued)

48 Fair values of financial instruments carried at fair value *(continued)*

Credit valuation adjustment/ debit valuation adjustment methodology

The group calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each group legal entity and, within each entity, for each counterparty to which the entity has exposure.

The group calculates the CVA by applying the probability of default ('PD') of the counterparty, conditional on the non-default of the group, to the expected positive exposure of the group to the counterparty and multiplying the result by the loss expected in the event of default. Conversely, the group calculates the DVA by applying the PD of the group, conditional on the non-default of the counterparty, to the expected positive exposure of the counterparty to the group, and multiplying by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

For most products, the group uses a simulation methodology to calculate the expected positive exposure to a counterparty. This incorporates a range of potential exposures across the portfolio of transactions with the counterparty over the life of the portfolio. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default ('LGD') assumption of 60% is generally adopted for developed market exposures, and 75% for emerging market exposures. Alternative loss given default assumptions may be adopted where both the nature of the exposure and the available data support this.

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 the mapping approach is not appropriate, using a simplified methodology, which generally follows 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 is used in the simulation methodology.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises when the underlying value of the derivative prior to any CVA is positively correlated to the probability of default by the counterparty. When there is significant wrong-way risk, a trade-specific approach is applied to reflect the wrong-way risk within the valuation.

With the exception of certain central clearing parties, the group includes all third-party counterparties in the CVA and DVA calculations and does not net these adjustments across the group entities. The group reviews and refines the CVA and DVA methodologies on an ongoing basis.

48 Fair values of financial instruments carried at fair value *(continued)*

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

	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$m	Derivatives HK$m
At 1 January 2015	**6,712**	**165**	**1,911**	**785**	**12,153**	**1,108**
Total gains or losses recognised in profit or loss	**43**	**7**	**276**	**705**	**(1,387)**	**872**
– Net trading income excluding net interest income	**–**	**7**	**–**	**705**	**(1,387)**	**872**
– Net income from other financial instruments designated at fair value	**–**	**–**	**276**	**–**	**–**	**–**
– Gains less losses from financial investments	**43**	**–**	**–**	**–**	**–**	**–**
Total gains or losses recognised in other comprehensive income	**(922)**	**(7)**	**(1)**	**(8)**	**(413)**	**(8)**
– Available-for-sale investments: fair value losses	**(777)**	**–**	**–**	**–**	**–**	**–**
– Exchange differences	**(145)**	**(7)**	**(1)**	**(8)**	**(413)**	**(8)**
Purchases	**548**	**992**	**1,940**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**4,424**	**–**
Sales	**(128)**	**(282)**	**(68)**	**–**	**–**	**–**
Deposits/settlements	**–**	**–**	**(807)**	**(75)**	**(3,257)**	**(75)**
Transfers out	**–**	**(33)**	**(805)**	**(227)**	**(4,435)**	**(247)**
Transfers in	**–**	**–**	**–**	**1**	**373**	**32**
At 31 December 2015	**6,253**	**842**	**2,446**	**1,181**	**7,458**	**1,682**
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	**–**	**7**	**101**	**244**	**9**	**(61)**
– Trading income excluding net interest income	**–**	**7**	**–**	**244**	**9**	**(61)**
– Net income from other financial instruments designated at fair value	**–**	**–**	**101**	**–**	**–**	**–**

Notes on the Financial Statements (continued)

48 Fair values of financial instruments carried at fair value *(continued)*

	Assets					Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2014	11,218	664	1,353	1,112	4,295	17,829	1,445
Total gains or losses recognised in profit or loss	1,166	(3)	291	(124)	3,332	(1,473)	109
– Net trading income excluding net interest income	–	(3)	–	(124)	–	(1,473)	109
– Net income from other financial instruments designated at fair value	–	–	291	–	–	–	–
– Gains less losses from financial investments	1,166	–	–	–	3,332	–	–
Total gains or losses recognised in other comprehensive income	(29)	(24)	–	(10)	(3,458)	(331)	(6)
– Available-for-sale investments: fair value losses	31	–	–	–	(3,458)	–	–
– Exchange differences	(60)	(24)	–	(10)	–	(331)	(6)
Purchases	1,359	421	587	–	–	–	–
Issues	–	–	–	–	–	4,950	–
Sales	(2,419)	(630)	(45)	–	(4,169)	–	–
Deposits/settlements	(4,583)	–	(527)	397	–	(3,814)	301
Transfers out	–	(274)	–	(624)	–	(5,085)	(847)
Transfers in	–	11	252	34	–	77	106
At 31 December 2014	6,712	165	1,911	785	–	12,153	1,108
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	(88)	(2)	296	47	–	(3)	(110)
– Net trading income excluding net interest income	–	(2)	–	47	–	(3)	(110)
– Net income from other financial instruments designated at fair value	–	–	296	–	–	–	–
– Impairment charges	(88)	–	–	–	–	–	–

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.*

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

Transfers out of Level 3 held for trading liabilities predominantly resulted from an increase in the observability of inputs such as correlations in pricing the instruments.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under 'Net trading income'.

Fair value changes on assets and liabilities designated at fair value are presented in the income statement under 'Net income/(expense) from financial instruments designated at fair value'.

Realised gains and losses from available-for-sale securities are presented under 'Gains less losses from financial investments' in the income statement while unrealised gains and losses are presented in 'Fair value changes taken to equity' within 'Available-for-sale investments' in other comprehensive income.

48 Fair values of financial instruments carried at fair value *(continued)*

Effects of changes in significant non-observable assumptions to reasonably possible alternatives

As discussed above, the fair values of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions:

Sensitivity of fair values to reasonably possible alternative assumptions

	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 2015				
Derivatives/trading assets/trading liabilities	**193**	**(177)**	**–**	**–**
Financial assets designated at fair value	**122**	**(122)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**401**	**(401)**
At 31 December 2014				
Derivatives/trading assets/trading liabilities	329	(322)	–	–
Financial assets designated at fair value	191	(191)	–	–
Financial investments: available-for-sale	–	–	672	(674)

Favourable and unfavourable changes are determined on the basis of sensitivity analysis. The sensitivity analysis aims to measure a range of fair values consistent with the application of a 95% confidence interval. Methodologies take account of the nature of the valuation technique employed, as well as the availability and reliability of observable proxy and historical data. When the available data is not amenable to statistical analysis, the quantification of uncertainty is judgemental, but remains guided by the 95% confidence interval.

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or the most unfavourable change from varying the assumptions individually.

Notes on the Financial Statements (continued)

48 Fair values of financial instruments carried at fair value *(continued)*

Quantitative information about significant unobservable inputs in Level 3 valuations

At 31 December 2015

Valuation technique	Key unobservable inputs	Assets-fair value HK$m	Liabilities-fair value HK$m	Range of inputs Lower	Higher
Structured notes and deposits					
Option model	Equity correlation	–	**1,110**	**0.35**	**0.93**
Option model	Equity volatility	–	**4,602**	**12%**	**55%**
Option model	Interest rate correlation	–	**869**	**0.43**	**0.99**
Option model	Foreign exchange volatility	–	**725**	**5%**	**27%**
Corporate bonds					
Market comparable approach	Bid quotes	**1,289**	–	**99.52**	**100.54**
Private equity including strategic investments					
Market comparable approach	Multiple	**3,373**	–	**0.72**	**37.04**
Net asset value	Equity valuation	**656**	–	**n/a**	**n/a**
Net asset value	Fund valuation	**2,559**	–	**n/a**	**n/a**
Broker pricing	Bid quotes	**555**	–	**0.41**	**0.42**
Other		**2,290**	**1,834**		
		10,722	**9,140**		

At 31 December 2014

Valuation technique	Key unobservable inputs	Assets-fair value HK$m	Liabilities-fair value HK$m	Range of inputs Lower	Higher
Structured notes and deposits					
Option model	Equity correlation	–	6,342	0.27	0.92
Option model	Equity volatility	–	3,354	12%	50%
Option model	Interest rate correlation	–	791	0.40	0.96
Option model	Foreign exchange volatility	–	1,509	4%	19%
Corporate bonds					
Market comparable approach	Bid quotes	765	–	97.60	99.69
Private equity including strategic investments					
Market comparable approach	Multiple	4,189	–	0.62	36.66
Net asset value	Equity valuation	704	–	n/a	n/a
Net asset value	Fund valuation	2,108	–	n/a	n/a
Broker pricing	Bid quotes	610	–	0.44	0.47
Other		1,197	1,265		
		9,573	13,261		

Key unobservable inputs to Level 3 financial instruments

The table above lists key unobservable inputs to Level 3 financial instruments, and provides the range of those inputs as at 31 December 2015 and 2014. A further description of the categories of key unobservable inputs is given below.

Volatility

Volatility is a measure of the anticipated future variability of a market price. Volatility tends to increase in stressed market conditions, and decrease in calmer market conditions. Volatility is an important input in the pricing of options. In general, the higher the volatility, the more expensive the option will be. This reflects both the higher probability of an increased return from the option, and the potentially higher costs that the group may incur in hedging the risks associated with the option. If option prices become more expensive, this will increase the value of the group's long option positions (i.e. the positions in which the group has purchased options), while the group's short option positions (i.e. the positions in which the group has sold options) will suffer losses.

48 Fair values of financial instruments carried at fair value *(continued)*

Volatility varies by underlying reference market price, and by strike and maturity of the option. Volatility also varies over time. As a result, it is difficult to make general statements regarding volatility levels. For example, while it is generally the case that foreign exchange volatilities are lower than equity volatilities, there may be examples in particular currency pairs or for particular equities where this is not the case.

Certain volatilities, typically those of a longer-dated nature, are unobservable. The unobservable volatility is then estimated from observable data. For example, longer-dated volatilities may be extrapolated from shorter-dated volatilities.

The range of unobservable volatilities quoted in the table reflects the wide variation in volatility inputs by reference to market price. For example, foreign exchange volatilities for a pegged currency may be very low, whereas for non-managed currencies, the foreign exchange volatility may be higher. As a further example, volatilities for deep-in-the money or deep-out-of-the-money equity options may be significantly higher than at-the-money options. For any single unobservable volatility, the uncertainty in the volatility determination is significantly less than the range quoted above.

Correlation

Correlation is a measure of the inter-relationship between two market prices. Correlation is a number between minus one and one. A positive correlation implies that the two market prices tend to move in the same direction, with a correlation of one implying that they always move in the same direction. A negative correlation implies that the two market prices tend to move in opposite directions, with a correlation of minus one implying that the two market prices always move in opposite directions.

Correlation is used to value more complex instruments where the payout is dependent upon more than one market price. For example, an equity basket option has a payout that is dependent upon the performance of a basket of single stocks, and the correlation between the price movements of those stocks will be an input to the valuation. This is referred to as equity-equity correlation. There is a wide range of instruments for which correlation is an input, and consequently a wide range of both same-asset correlations (e.g. equity-equity correlation) and cross-asset correlations (e.g. foreign exchange rate-interest rate correlation) used. In general, the range of same-asset correlations will be narrower than the range of cross-asset correlations.

Correlation may be unobservable. Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, the group trade prices, proxy correlations and examination of historical price relationships.

The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair. For any single unobservable correlation, the uncertainty in the correlation determination is likely to be less than the range quoted above.

Private equity including strategic investments

The group's private equity and strategic investments are generally classified as available-for-sale and are not 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. Given the bespoke nature of the analysis in respect of each holding, it is not practical to quote a range of key unobservable inputs.

Inter-relationships between key unobservable inputs

Key unobservable inputs to Level 3 financial instruments may not be independent of each other. As described above, market variables may be correlated. This correlation typically reflects the manner in which different markets tend to react to macro-economic or other events. For example, improving economic conditions may lead to a 'risk on' market, in which prices of risky assets such as equities and high yield bonds will rise, while 'safe haven' assets such as gold and US Treasuries decline. Furthermore, the impact of changing market variables upon the group portfolio will depend upon the group's net risk position in respect of each variable. For example, increasing high-yield bond prices will benefit long high-yield bond positions, but the value of any credit derivative protection held against those bonds will fall.

Notes on the Financial Statements (continued)

49 Fair values of financial instruments not carried at fair value

The classification of financial instruments is determined in accordance with the accounting policies set out in note 3. Fair values are determined according to the hierarchy set out in note 48.

Fair values of financial instruments which are not carried at fair value and bases of valuation

		Fair values			
			Valuation techniques		
	Carrying amount	Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Total
At 31 December 2015	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Assets					
Reverse repurchase agreements – non-trading	**212,779**	**–**	**205,434**	**7,432**	**212,866**
Placings with and advances to banks	**421,221**	**–**	**411,044**	**10,387**	**421,431**
Loans and advances to customers	**2,762,290**	**–**	**44,348**	**2,708,923**	**2,753,271**
Financial investment debt securities	**228,599**	**4,098**	**231,821**	**–**	**235,919**
Liabilities					
Repurchase agreements – non-trading	**16,158**	**–**	**16,158**	**–**	**16,158**
Deposits by banks	**148,294**	**–**	**147,826**	**468**	**148,294**
Customer accounts	**4,640,076**	**–**	**4,640,626**	**–**	**4,640,626**
Debt securities in issue	**40,859**	**–**	**40,898**	**–**	**40,898**
Subordinated liabilities	**8,003**	**–**	**1,838**	**5,027**	**6,865**
Preference shares	**36,553**	**–**	**–**	**36,863**	**36,863**
At 31 December 2014					
Assets					
Reverse repurchase agreements – non-trading	218,901	–	210,267	8,709	218,976
Placings with and advances to banks	488,313	–	479,348	9,106	488,454
Loans and advances to customers	2,815,216	–	22,940	2,780,358	2,803,298
Financial investment debt securities	182,626	4,768	185,968	–	190,736
Liabilities					
Repurchase agreements – non-trading	28,379	–	28,379	–	28,379
Deposits by banks	226,713	–	226,044	668	226,712
Customer accounts	4,479,992	–	4,479,985	–	4,479,985
Debt securities in issue	45,297	1,129	43,316	880	45,325
Subordinated liabilities	12,832	–	2,267	9,683	11,950
Preference shares	36,582	–	–	32,623	32,623

The majority of the financial instruments not carried at fair value are measured at amortised cost. 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 re-price to current market rates frequently:

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission to other banks
Hong Kong Government certificates of indebtedness	Hong Kong currency notes in circulation
Items in the course of collection from other banks	Acceptances and endorsements
Acceptances and endorsements	Short-term payables within 'Other liabilities'
Short-term receivables within 'Other assets'	Accruals
	Investment contracts with discretionary participation features
	Accrued income within 'Liabilities under insurance contracts'

49 Fair values of financial instruments not carried at fair value *(continued)*

Valuation

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 price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It does not reflect the economic benefits and costs that the group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available.

Repurchase and reverse repurchase agreements – non-trading

Fair values are estimated by using discounted cash flows, applying current rates. Fair values approximate carrying amounts as their balances are generally short dated.

Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. These assumptions may include value estimates from third party brokers which reflect over-the-counter trading activity; forward looking discounted cash flow models using assumptions which the group believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors.

The fair value of a loan reflects loan impairments at the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

Financial investments

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration the prices and future earnings streams of equivalent quoted securities.

Deposits by banks and customer accounts

Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is approximated by its carrying value.

Debt securities in issue and subordinated liabilities

Fair values are estimated by discounting future cash flows using discount rates for the applicable maturities and taking own credit spread into account.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the group as a going concern.

50 Structured entities

The group enters into certain transactions with customers in the ordinary course of business which involve the use of structured entities ('SEs') to facilitate or secure customer transactions. Some of these structures are complex or non-transparent. The group's arrangements that involve SEs are authorised centrally when they are established to ensure appropriate purpose and governance. The activities of SEs administered by the group are closely monitored by senior management. The group has involvement with both consolidated and unconsolidated SEs, which may be established by the group or by a third party. Structured entities are assessed for consolidation in accordance with the accounting policy set out in note 1(c).

The group's transactions with consolidated and unconsolidated SEs are set out below.

Structured credit transactions

The group provides structured credit products to third-party professional and institutional investors who wish to obtain exposure to a reference portfolio of debt instruments.

In such structures, the investor receives returns referenced to the underlying portfolio by purchasing notes issued by the SEs. The group enters into contracts with the SE, including derivatives, in order to pass the required risks and rewards of the reference portfolios to the SEs.

In certain transactions the group is exposed to risk often referred to as gap risk. Gap risk typically arises in transactions where the aggregate potential claims against the SE by the group pursuant to one or more derivatives could be greater than the value of the collateral held by the SE and securing such derivatives. The group often mitigates such gap risk by ensuring high quality collateral, hedging the risk, or incorporating features allowing managed liquidation of the portfolio.

Securitisations by the group

The group uses SEs to securitise customer loans and advances that it has originated in order to diversify its sources of funding for asset origination and for capital efficiency purposes. The loans and advances are transferred by the group to the SEs for cash, and the SEs issue debt securities to investors to fund the cash purchases. The group may also act as a derivative counterparty or provide a guarantee. Credit enhancements to the underlying assets may be provided to obtain investment grade ratings on the senior debt issued by the SEs.

The group's exposure is the aggregate of any holdings of notes issued by these vehicles, the reserve account positions intended to provide credit support under certain pre-defined circumstances to senior note holders and any derivatives or guarantees provided. Off balance sheet financial guarantees are disclosed in note 41(b).

Third-party financing SEs

The group also transacts with third party SEs in the normal course of business for a number of purposes, for example, to provide finance to public and private sector infrastructure projects, for asset and structured finance transactions and for customers to raise finance against security.

The assets are generally ring-fenced by the SE and, in most cases, the customer, a sponsor or third party provides some credit enhancement or guarantee in the structure. The group also has interests in third-party established structured entities by holding notes issued by these entities or entering into derivatives where the group absorbs risk from the entities.

The derivative and lending exposures are generally secured by the SE's assets, with credit enhancement and/or guarantees provided by third parties. The group's risk in relation to the derivative contracts and trading positions with these SEs is managed within the group's market risk framework (see 'Market Risk' in the 'Risk Report'). Credit risk is managed within the group's credit risk framework (see 'Credit Risk' in the 'Risk Report').

50 Structured entities *(continued)*

Funds

The group has established and managed money market funds and non-money market investment funds to provide customers with investment opportunities. The group, as the fund manager, may be entitled to receive management and performance fees based on the assets under management.

The group purchases and holds units of HSBC managed and third party managed funds in order to facilitate both business and customer needs. The majority of these funds held relate to the insurance business. When the group is deemed to be acting as a principal rather than an agent in its role as a fund manager, the group controls and hence consolidates these funds.

The risks of unit holding are managed under a trading mandate or the investment risks associated with the insurance business are managed through matching assets and liabilities for non-linked products. Investment strategies are set with the intention to provide sufficient investment return to satisfy policyholders' reasonable expectations. Policyholders bear the market risk for unit-linked products. This is discussed in more detail in 'Insurance Risk' within the 'Risk Report'.

In addition, the group enters into derivative contracts to facilitate risk management solutions for third party managed funds. Note 12 sets out information in respect of derivatives entered into by the group.

Unconsolidated structured entities

The term 'unconsolidated structured entities' refers to all SEs that are not controlled by the group.

The table below shows the total assets of unconsolidated SEs in which the group has an interest at the reporting date, as well as the group's maximum exposure to loss in relation to those interests.

The maximum exposure to loss from the group's interests in unconsolidated SEs represents the maximum loss that the group could incur as a result of its involvement with unconsolidated SEs regardless of the probability of the loss being incurred.

For commitments and guarantees, the maximum exposure to loss is the notional amount of potential future losses.

For retained and purchased investments in and loans to unconsolidated SEs, the maximum exposure to loss is the carrying value of these interests at the balance sheet reporting date.

The maximum exposure to loss is stated gross of the effects of hedging and collateral arrangements entered into to mitigate the group's exposure to loss.

Income from unconsolidated SEs includes recurring and non-recurring fees, interest, dividends, gains or losses on the re-measurement or derecognition of interests in structured entities, any mark-to-market gains or losses on a net basis and gains or losses from the transfer of assets and liabilities to the structured entities.

50 Structured entities *(continued)*

Nature and risks associated with the group's interests in unconsolidated structured entities

	Securitisations HK$m	HSBC managed funds HK$m	Non-HSBC managed funds HK$m	Other HK$m	Total HK$m
At 31 December 2015					
Total assets	**30,631**	**622,340**	**5,527,243**	**57,366**	**6,237,580**
The group's interest- assets					
Trading assets	**–**	**99**	**–**	**–**	**99**
Financial assets designated at fair value	**–**	**15,506**	**40,142**	**–**	**55,648**
Derivatives	**–**	**–**	**–**	**299**	**299**
Loans and advances to customers	**8,654**	**–**	**–**	**6,918**	**15,572**
Financial investments	**–**	**–**	**435**	**–**	**435**
Other assets	**–**	**–**	**–**	**283**	**283**
Total assets in relation to the group's interests in the unconsolidated structured entities[1]	**8,654**	**15,605**	**40,577**	**7,500**	**72,336**
The group's interest- liabilities					
Derivatives	**205**	**–**	**–**	**2**	**207**
Total liabilities in relation to the group's interests in the unconsolidated structured entities	**205**	**–**	**–**	**2**	**207**
The group's maximum exposure	**9,305**	**15,605**	**40,598**	**7,946**	**73,454**
At 31 December 2014[2]					
Total assets	19,442	978,979	7,022,209	45,903	8,066,533
The group's interest- assets					
Trading assets	–	98	–	–	98
Financial assets designated at fair value	–	16,852	40,576	–	57,428
Derivatives	14	–	–	187	201
Loans and advances to customers	6,270	–	–	8,645	14,915
Financial investments	–	–	325	–	325
Other assets	–	–	–	387	387
Total assets in relation to the group's interests in the unconsolidated structured entities[1]	6,284	16,950	40,901	9,219	73,354
The group's interest- liabilities					
Derivatives	111	–	–	10	121
Total liabilities in relation to the group's interests in the unconsolidated structured entities	111	–	–	10	121
The group's maximum exposure	7,001	16,950	40,922	9,606	74,479

1 *Amongst the group's interests in the assets of the unconsolidated structured entities, HK$15,506m (2014: HK$16,853m) of HSBC managed funds (out of total assets of HK$15,605m (2014: HK$16,950m)) and HK$40,547m (2014: HK$40,777m) of non-HSBC managed funds (out of total assets of HK$40,577m (2014: HK$40,901m)) are held by the insurance business.*

2 *Certain 2014 balances have been re-presented in accordance with current year disclosure convention.*

Structured entities sponsored by the group

The definition of a sponsor is given in note 3(n). In some cases, the group does not have an interest in the unconsolidated structured entities that it has sponsored at the reporting date.

The amount of assets transferred to and income received from such sponsored during 2015 and 2014 was not significant.

51 Bank balance sheet and statement of changes in equity

Bank balance sheet at 31 December 2015

	2015 HK$m	2014 HK$m
ASSETS		
Cash and sight balances at central banks	**112,427**	120,468
Items in the course of collection from other banks	**18,055**	15,888
Hong Kong Government certificates of indebtedness	**220,184**	214,654
Trading assets	**215,109**	298,365
Derivatives	**360,222**	374,876
Financial assets designated at fair value	**911**	1,257
Reverse repurchase agreements – non-trading	**94,592**	116,113
Placings with and advances to banks	**179,109**	206,309
Loans and advances to customers	**1,546,056**	1,590,711
Financial investments	**950,504**	721,983
Amounts due from Group companies	**407,194**	404,136
Investments in subsidiaries	**72,395**	70,849
Interests in associates and joint ventures	**39,830**	39,830
Goodwill and intangible assets	**4,361**	4,307
Property, plant and equipment	**80,513**	76,884
Deferred tax assets	**924**	664
Other assets	**80,271**	94,617
Total assets	**4,382,657**	4,351,911
LIABILITIES		
Hong Kong currency notes in circulation	**220,184**	214,654
Items in the course of transmission to other banks	**21,960**	22,512
Repurchase agreements – non-trading	**6,192**	21,033
Deposits by banks	**92,969**	174,385
Customer accounts	**2,972,413**	2,814,510
Trading liabilities	**101,342**	98,549
Derivatives	**350,281**	353,645
Financial liabilities designated at fair value	**8,744**	9,180
Debt securities in issue	**32,054**	32,089
Retirement benefit liabilities	**4,465**	3,663
Amounts due to Group companies	**141,047**	187,935
Other liabilities and provisions	**47,809**	47,777
Current tax liabilities	**1,451**	1,840
Deferred tax liabilities	**6,806**	6,435
Subordinated liabilities	**6,204**	9,337
Preference shares	**36,451**	36,474
Total liabilities	**4,050,372**	4,034,018
EQUITY		
Share capital	**96,052**	96,052
Other equity instruments	**14,737**	14,737
Other reserves	**6,558**	7,253
Retained profits	**214,938**	199,851
Total equity	**332,285**	317,893
Total equity and liabilities	**4,382,657**	4,351,911

Directors
Stuart Gulliver
Peter Wong

Notes on the Financial Statements (continued)

51 Bank balance sheet and statement of changes in equity *(continued)*

Bank statement of changes in equity for the year ended 31 December 2015

	2015								
				Other reserves					
	Share capital HK$m	Other equity instruments HK$m	Retained profits HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total equity HK$m
At 1 January	96,052	14,737	199,851	28,933	2,575	(106)	(8,825)	(15,324)	317,893
Profit for the year	–	–	52,541	–	–	–	–	–	52,541
Other comprehensive income (net of tax)	–	–	(1,026)	5,108	(1,220)	125	(4,042)	–	(1,055)
Available-for-sale investments	–	–	–	–	(1,220)	–	–	–	(1,220)
Cash flow hedges	–	–	–	–	–	125	–	–	125
Property revaluation	–	–	(142)	5,108	–	–	–	–	4,966
Actuarial losses on defined benefit plans	–	–	(884)	–	–	–	–	–	(884)
Exchange differences	–	–	–	–	–	–	(4,042)	–	(4,042)
Total comprehensive income	–	–	51,515	5,108	(1,220)	125	(4,042)	–	51,486
Dividends paid[7]	–	–	(37,405)	–	–	–	–	–	(37,405)
Movement in respect of share-based payment arrangements	–	–	12	–	–	–	–	329	341
Other movements	–	–	(5)	(15)	–	–	–	(10)	(30)
Transfers	–	–	970	(970)	–	–	–	–	–
At 31 December	96,052	14,737	214,938	33,056	1,355	19	(12,867)	(15,005)	332,285

51 Bank balance sheet and statement of changes in equity *(continued)*

Bank statement of changes in equity for the year ended 31 December 2015 *(continued)*

	2014								
				Other reserves					
	Share capital HK$m	Other equity instruments HK$m	Retained profits HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total equity HK$m
At 1 January	85,319	–	183,458	28,256	4,562	188	(7,127)	(15,542)	279,114
Profit for the year	–	–	59,480	–	–	–	–	–	59,480
Other comprehensive income (net of tax)	–	–	(946)	3,269	(1,987)	(294)	(1,698)	–	(1,656)
Available-for-sale investments	–	–	–	–	(1,987)	–	–	–	(1,987)
Cash flow hedges	–	–	–	–	–	(294)	–	–	(294)
Property revaluation	–	–	(121)	3,269	–	–	–	–	3,148
Actuarial losses on defined benefit plans	–	–	(825)	–	–	–	–	–	(825)
Exchange differences	–	–	–	–	–	–	(1,698)	–	(1,698)
Total comprehensive income	–	–	58,534	3,269	(1,987)	(294)	(1,698)	–	57,824
Shares issued	10,733	–	–	–	–	–	–	–	10,733
Other equity instruments issued[6]	–	14,737	–	–	–	–	–	–	14,737
Dividends paid	–	–	(42,750)	–	–	–	–	–	(42,750)
Movement in respect of share-based payment arrangements	–	–	(123)	–	–	–	–	218	95
Other movements	–	–	5	(1,865)	–	–	–	–	(1,860)
Transfers	–	–	727	(727)	–	–	–	–	–
At 31 December	96,052	14,737	199,851	28,933	2,575	(106)	(8,825)	(15,324)	317,893

1 *The property revaluation reserve represents the difference between the fair value of the property and its depreciated cost.*
2 *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.*
3 *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.*
4 *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.*
5 *The other reserves mainly comprise of the share-based payment reserve account, purchase premium arising from transfer of business within the HSBC Group 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.*
6 *During 2014, the Bank issued new capital instruments that are included in the group's capital base as Basel III-compliant additional tier 1 capital under the Banking (Capital) Rules.*
7 *Including distributions paid on perpetual subordinated loans classified as equity under HKFRSs.*

Notes on the Financial Statements (continued)

52 Legal proceedings and regulatory matters

The group is party to legal proceedings and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described below, the Bank considers that none of these matters are material. The recognition of provisions is determined in accordance with the accounting policies set out in note 3(v). While the outcome of legal proceedings and regulatory matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of these matters as at 31 December 2015. Any provision recognised does not constitute an admission of wrongdoing or legal liability. It is not practicable to provide an aggregate estimate of potential liability for our legal proceedings and regulatory matters as a class of contingent liabilities.

Anti-money laundering and sanctions-related matter

In October 2010, HSBC Bank USA entered into a consent cease-and-desist order with the Office of the Comptroller of the Currency (the 'OCC') and the indirect parent of that company, HSBC North America Holdings Inc. ('HNAH'), entered into a consent cease-and-desist order with the Federal Reserve Board (the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including risk management related to US Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. Steps continue to be taken to address the requirements of the Orders.

In December 2012, HSBC Holdings plc, HNAH and HSBC Bank USA entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA, AML and sanctions laws. Among those agreements, HSBC Holdings plc and HSBC Bank USA entered into a five-year deferred prosecution agreement with the US Department of Justice ('DoJ'), the US Attorney's Office for the Eastern District of New York, and the US Attorney's Office for the Northern District of West Virginia (the 'US DPA'); and HSBC Holdings plc consented to a cease-and-desist order and HSBC Holdings plc and HNAH consented to a civil money penalty order with the Federal Reserve Board ('FRB'). HSBC Holdings plc also entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions, as well as an undertaking with the UK Financial Conduct Authority ('FCA') to comply with certain forward-looking AML and sanctions-related obligations. In addition, HSBC Bank USA entered into a civil money penalty order with the Financial Crimes Enforcement Network ('FinCEN') of the US Treasury Department and a separate civil money penalty order with the OCC.

Under these agreements, HSBC Holdings plc and HSBC Bank USA made payments totalling $1.9bn to US authorities. In July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of that agreement. An independent compliance monitor (the 'Monitor') was appointed in 2013 under the agreements entered into with the DoJ and the FCA to produce annual assessments of the effectiveness of HSBC's AML and sanctions compliance programme. Additionally, the Monitor is serving as HSBC's independent consultant under the consent order of the FRB. In January 2016, the Monitor delivered his second annual follow-up review report as required by the US DPA.

Under the terms of the US DPA, upon notice and an opportunity to be heard, the DoJ has sole discretion to determine whether HSBC has breached the US DPA. Potential consequences of breaching the US DPA could include the imposition of additional terms and conditions on HSBC, an extension of the agreement, including its monitorship, or the criminal prosecution of HSBC, which could, in turn, entail further financial penalties and collateral consequences.

HSBC Bank USA also entered into a separate consent order with the OCC requiring it to correct the circumstances and conditions as noted in the OCC's then most recent report of examination, and imposing certain restrictions on HSBC Bank USA directly or indirectly acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. HSBC Bank USA also entered into a separate consent order with the OCC requiring it to adopt an enterprise-wide compliance programme.

These settlements with US and UK authorities have led to private litigation, and do not preclude further private litigation related to HSBC's compliance with applicable BSA, AML and sanctions laws or other regulatory or law enforcement actions for BSA, AML, sanctions or other matters not covered by the various agreements.

52 Legal proceedings and regulatory matters *(continued)*

Tax investigations

The Bank continues to cooperate with the relevant US and other authorities, including with respect to US-based clients of the Bank in India.

In addition, various tax administration, regulatory and law enforcement authorities around the world, including in India, are conducting investigations and reviews of HSBC Swiss Private Bank and other HSBC entities in connection with allegations of tax evasion or tax fraud, money laundering and unlawful cross-border banking solicitation. The Indian tax authority issued a summons and request for information to the Bank in India.

With respect to each of these ongoing matters, the Bank and other HSBC companies are cooperating with the relevant authorities in a manner consistent with relevant laws. There are many factors that may affect the range of outcomes, and the resulting financial impact, of these investigations and reviews, which could be significant.

In light of the media attention regarding these matters, it is possible that other tax administration, regulatory or law enforcement authorities will also initiate or enlarge similar investigations or regulatory proceedings.

Foreign exchange rate investigations

Various regulators and competition and law enforcement authorities around the world, including in South Korea and elsewhere, are conducting investigations and reviews into trading by HSBC and others on the foreign exchange markets. The Bank and other HSBC companies have been cooperating with these ongoing investigations and reviews.

There are many factors that may affect the range of outcomes, and the resulting financial impact of these investigations, which could be significant.

Hiring practices investigation

The US Securities and Exchange Commission (the 'SEC') is investigating multiple financial institutions, including HSBC Holdings plc, in relation to hiring practices of candidates referred by or related to government officials or employees of state-owned enterprises in Asia Pacific. HSBC has received various requests for information and is cooperating with the SEC's investigation.

Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of this matter, including the timing or any possible impact on HSBC, which could be significant.

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 Events after the balance sheet date

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

55 Approval of financial statements

The financial statements were approved and authorised for issue by the Board of Directors on 22 February 2016.

Printed by DG3 Asia Limited, Hong Kong, on Printspeed White (cover) and Innotech White (text pages) using vegetable oil-based inks. Made in Austria, the cover board comprises 82% virgin fibre, 9% de-inked post-consumer waste and 9% pre-consumer waste. Made in China, the text paper comprises 76% virgin fibre, 12% de-inked post-consumer waste and 12% pre-consumer waste. Pulps used are totally chlorine-free.

The FSC™ logo identifies products which contain wood from well-managed forests certified in accordance with the rules of the Forest Stewardship Council®.

FSC www.fsc.org
MIX
Paper from responsible sources
FSC™ C019970

GPS3905