



恒生銀行  
HANG SENG BANK

# Interim Report 2014

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## 2014 中期報告

The printed version of Hang Seng Bank's Interim Report 2014  
will replace this version in late August 2014.

恒生銀行2014年中期報告之印刷本將於2014年8月下旬取代此版本。

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

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

## RESULTS IN BRIEF

	30 June 2014	30 June 2013
<b>For the half-year ended</b>	<b>HK\$m</b>	<b>HK\$m</b>
Operating profit excluding loan impairment charges and other credit risk provisions	9,833	9,132
Operating profit	9,496	8,934
Profit before tax*	9,877	18,773
Profit attributable to shareholders*	8,468	18,468
	%	%
Return on average shareholders' funds*	15.9	35.9
Cost efficiency ratio	32.1	32.2
Average liquidity ratio	34.5	35.8
	<b>HK\$</b>	<b>HK\$</b>
Earnings per share*	4.43	9.66
Dividends per share	2.20	2.20

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	At 30 June 2014	At 31 December 2013
<b>At period-end</b>	<b>HK\$m</b>	<b>HK\$m</b>
Shareholders' funds	109,501	107,778
Total assets	1,195,964	1,143,730
	%	%
Capital ratios under Basel III		
- Common Equity Tier 1 ("CET1") Capital Ratio	11.8	13.8
- Tier 1 Capital Ratio	11.8	13.8
- Total Capital Ratio	14.2	15.8

### \* *Industrial Bank Co., Ltd. ("Industrial Bank") reclassification in 2013*

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

	Half-year ended 30 June 2014	Half-year ended 30 June 2013
Profit before tax (HK\$m)	9,877	10,319
Profit attributable to shareholders (HK\$m)	8,468	8,951
Earnings per share (HK\$)	4.43	4.68
Return on average shareholders' funds (%)	16.6	19.0

## CHAIRMAN'S STATEMENT

With developments in the global and regional economies continuing to create uncertain market conditions – particularly in the early part of the year – Hang Seng Bank maintained good growth momentum in the first half of 2014. We reinforced our reputation for service excellence and further strengthened customer relationships by enhancing our portfolio of products and services, leveraging the close cross-border connectivity of our network and improving service channels and operational efficiency.

Operating profit increased by 6% to HK\$9,496m. However, the impact of our reclassification of Industrial Bank in 2013 saw profit attributable to shareholders and earnings per share both fall by 54% to HK\$8,468m and HK\$4.43 respectively. Excluding the Industrial Bank reclassification, profit attributable to shareholders and earnings per share were both down 5%, reflecting a HK\$769m decrease in the net surplus on property revaluation.

Return on average shareholders' funds was 15.9%, compared with 35.9% in the first half of 2013. Excluding the Industrial Bank reclassification, return on average shareholders' funds was 16.6%, compared with 19.0% in the first half of last year.

The Directors have declared a second interim dividend of HK\$1.10 per share, bringing the total distribution for the first half of 2014 to HK\$2.20 per share, the same as in the first half of 2013.

### Economic Environment

The global economy recorded a slow start in 2014, with emerging market equities and currencies falling sharply in January and harsh winter conditions in the US contributing to a first-quarter contraction in its economy. Looking ahead, improved economic conditions in the second quarter and ongoing recovery in the Eurozone region are providing cause for cautious optimism, although the European Central Bank continues to take action to prevent inflation from falling further below its target.

Hong Kong's economy expanded by 2.5% in the first quarter, compared with a 2.9% increase for 2013. Domestic demand continued to be a major growth driver, although household spending appears to have slowed after years of outpacing overall economic expansion. With the recent improvement in the global economy, trade activity is likely to rebound in the second half of the year and we expect Hong Kong's real GDP to grow by 3.3% for the year.

After first-quarter GDP growth of 7.4%, mainland China's economy achieved growth of 7.5% in the second quarter, suggesting that targeted measures by the Government are succeeding in stimulating growth. While property investment may remain weak for some time, a recovery in developed economies should see demand for exports increase in the second half and we expect the Mainland economy to expand by 7.4% for 2014.

Challenges such as the rolling back of quantitative easing measures in the US will continue to create downside risks, but closer economic integration in the Greater China region and Hong Kong's position as a primary centre for offshore renminbi financial services will create new business opportunities.

We will continue with initiatives to leverage our competitive strengths and to improve efficiency across our business to generate increasing value for our customers and shareholders.

**Raymond Ch'ien**

*Chairman*

Hong Kong, 4 August 2014

## CHIEF EXECUTIVE'S REPORT

Under challenging operating conditions, Hang Seng Bank achieved solid growth, with increases in income and profit across all business groups, in the first half of 2014.

Operating profit excluding loan impairment charges rose by 8% to HK\$9,833m compared with the first half of 2013. Operating profit increased by 6% to HK\$9,496m. Compared with the second half of last year, which benefited from HK\$995 million in dividend income from Industrial Bank, operating profit excluding loan impairment charges and operating profit were both broadly unchanged. Excluding the dividend impact from Industrial Bank, operating profit grew by 12%.

The accounting gain on Industrial Bank's reclassification in 2013 and lower gains from property disposal and revaluation resulted in a 54% drop in profit attributable to shareholders to HK\$8,468m and a 47% decline in profit before tax to HK\$9,877m. Compared with the second half of 2013, profit attributable to shareholders and profit before tax increased by 3% and 2% respectively.

Leveraging our trusted brand and strong market position, we strategically deployed resources and implemented customer-focused initiatives to support sustainable growth in our core business lines and enhance our cross-border and renminbi-related propositions.

In April, we further enriched our wealth management proposition with the signing of an exclusive 10-year distribution agreement with international healthcare company Bupa, under which a range of bespoke medical insurance products and services will be offered to Hang Seng customers.

We upgraded our branch network and increased our number of Prestige and Preferred Banking Centres to better serve the needs of targeted commercial and wealth clients.

New Hang Seng Bank (China) Ltd outlets in Chengdu and the Shanghai Free Trade Zone extended our cross-border network, strengthening our ability to capture new business opportunities in mainland China. In June, Hang Seng China successfully raised RMB1bn in Hong Kong through its debut offshore renminbi bond issue with positive response from a diverse group of investors.

Net interest income increased by 8% to HK\$9,671m, underpinned by a 4% increase in average interest-earning assets and an 8-basis-point improvement in net interest margin to 1.92%. In competitive market conditions, we continued to focus on quality assets and good balance sheet management, recording a 5% increase in average customer deposits and an 8% rise in average customer loans and advances.

Non-interest income grew by 7% to HK\$4,802m, benefiting from the 4% increase in net fee income. Our diverse range of products and swift response to the changing market generated a 4% rise in wealth management income amidst uncertain market conditions.

Our cost efficiency ratio improved to 32.1% – down 10 basis points and 50 basis points compared with the first and second halves of 2013 respectively.

On 30 June 2014, our total capital ratio under Basel III was 14.2% and our Common Equity Tier 1 and Tier 1 capital ratios were both 11.8%, compared with 15.8% and 13.8% respectively at 2013 year-end.

### Corporate Responsibility

As Hong Kong's leading domestic bank, our long-term success is closely aligned with the economic growth and well-being of our local communities. To drive sustainable development, we continue to emphasise long-term relationships and our commitment to corporate responsibility. Our aim is to contribute to creating healthy and engaged communities that will, in turn, support our own growth in the years ahead.

As part of our strong focus on youth development activities, we supported close to 180 education programmes and workshops in 2013, reaching some 100,000 young people. The Hang Seng Bank - Leaders to Leaders Lecture Series provided local students with a valuable opportunity to engage in direct dialogue with prominent community leaders. We added a live webcast for the first time last year, enabling us to reach an additional 30,000 individuals. We were honoured to receive a Gold Award for Corporate Social Responsibility earlier this year at the 11th China Golden Awards for Excellence in Public Relations, organised by the China International Public Relations Association, for our work under the Series.

Other recognition of our sustainability performance includes a second consecutive year as the only Hong Kong corporation to be included on the 'Global 100 Most Sustainable Corporations in the World' compiled by Corporate Knights, and an A+ rating under Global Reporting Initiative sustainability reporting guidelines for our Corporate Sustainability Report for a third consecutive year.

### **Aligned for Sustainable Growth**

We are committed to driving long-term business growth by upholding service excellence. We will continue to provide a premium customer service experience and remain well positioned to respond effectively to new business opportunities, proactively manage emerging risks and maintain high standards of corporate governance.

We will build on our strong brand and market leadership to generate balanced growth with further investments in technology, staff development and our cross-border network and capabilities.

I would like to take this opportunity to thank our staff for their dedication and contribution to our business success. Their commitment and drive will ensure that we will continue to sustain quality growth in our core businesses to the benefit of our customers and shareholders.

**Rose Lee**

*Vice-Chairman and Chief Executive*

Hong Kong, 4 August 2014

# FINANCIAL REVIEW

## FINANCIAL PERFORMANCE

### Income Statement

#### Summary of financial performance

<i>Figures in HK\$m</i>	<i>Half-year ended 30 June 2014</i>	<i>Half-year ended 30 June 2013</i>	<i>Half-year ended 31 December 2013</i>
Total operating income	<b>21,362</b>	19,897	19,939
Operating expenses	<b>4,640</b>	4,345	4,758
Operating profit	<b>9,496</b>	8,934	9,476
Profit before tax	<b>9,877</b>	18,773	9,723
Profit attributable to shareholders	<b>8,468</b>	18,468	8,210
Earnings per share (in HK\$)	<b>4.43</b>	9.66	4.29

Hang Seng Bank Limited ('the Bank') and its subsidiaries ('the Group') reported an unaudited profit attributable to shareholders of HK\$8,468m for the first half of 2014, down 54.1% compared with the first half of 2013 which benefited from the HK\$9,517m accounting gain on the reclassification of Industrial Bank Co., Ltd ('Industrial Bank'). Earnings per share were down 54.1% at HK\$4.43. Excluding the Industrial Bank reclassification, attributable profit fell by 5.4% mainly due to lower property revaluation gains. Attributable profit rose by 3.1% when compared with the second half of 2013.

**Operating profit excluding loan impairment charges and other credit risk provisions grew by HK\$701m, or 7.7%, to HK\$9,833m.**

This reflected growth in net interest income, driven by balance sheet growth and increased non-interest income from wealth management businesses. Under challenging operating conditions, the Bank achieved good growth, with increases in income and profit across all business groups in the first half of 2014. Compared with the second half of 2013, operating profit excluding loan impairment charges and other credit risk provisions remained broadly unchanged. Excluding the dividend received from Industrial Bank, operating profit excluding loan impairment charges and other credit risk provisions grew by 11.5%, driven by the growth in both net interest income and non-interest income together with lower operating expenses.

**Net interest income rose by HK\$702m, or 7.8%, to HK\$9,671m,** driven mainly by the 3.6% increase in average interest-earning assets and an improvement in the net interest margin.

<i>Figures in HK\$m</i>	<i>Half-year ended 30 June 2014</i>	<i>Half-year ended 30 June 2013</i>	<i>Half-year ended 31 December 2013</i>
Net interest income/(expense) arising from:			
- financial assets and liabilities that are not at fair value through profit and loss	<b>10,754</b>	9,705	10,537
- trading assets and liabilities	<b>(1,085)</b>	(770)	(927)
- financial instruments designated at fair value	<b>2</b>	34	25
	<b>9,671</b>	<b>8,969</b>	<b>9,635</b>
Average interest-earning assets	<b>1,016,759</b>	981,814	991,320
Net interest spread	<b>1.79 %</b>	1.73 %	1.81 %
Net interest margin	<b>1.92 %</b>	1.84 %	1.93 %

Average interest-earning assets increased by HK\$34.9bn, or 3.6%, compared with the same period last year. The increase was underpinned by the 8.0% growth in average customer lending, with notable growth in corporate and commercial and mortgage lending. The rise in net interest income also included higher contributions from offshore RMB business as Treasury has been actively managing the interest rate risk and assessing different market opportunities for better yield enhancement of the commercial surplus. Partially offsetting this increase was a lower contribution from the insurance debt securities portfolios as the Bank re-balanced assets under the low interest rate environment.

Net interest margin widened by eight basis points to 1.92% whilst the net interest spread improved by six basis points to 1.79%. In Hong Kong, the spread on customer lending improved, notably on corporate and commercial term lending, though this was offset in part by the spread compression in trade-related and mortgage lending. On the back of the Group's flexible deposit acquisition strategy to support balanced growth, average customer deposit balances increased, though the benefit of this growth was more than offset by narrower deposit spreads. On the Mainland, the net interest margin and net interest spread widened, reflecting the improved deposit spread, coupled with a less volatile interbank market, outweighing the compression of loan spreads.

The contribution from net free funds grew by two basis points to 0.13%, benefiting from the modest increase in the average interest rate.

Compared with the second half of 2013, net interest income was broadly unchanged, reflecting the combined effect of an increase in average interest earning assets, widening loan spreads, improved returns from offshore RMB business and less volatility in the Mainland interbank market but offset by lower deposit spreads and more calendar days in the second half. The net interest margin has stabilised but remains at a compressed level.

The HSBC Group reports interest income and interest expense arising from financial assets and financial liabilities held for trading as 'Net trading income', while that arising from financial instruments designated at fair value through profit and loss is reported as 'Net income from financial instruments designated at fair value' (other than for debt securities in issue and subordinated liabilities, together with derivatives managed in conjunction with them).



The table below presents the net interest income of Hang Seng, as included in the HSBC Group accounts:

<i>Figures in HK\$m</i>	<i>Half-year ended 30 June 2014</i>	<i>Half-year ended 30 June 2013</i>	<i>Half-year ended 31 December 2013</i>
Net interest income and expense reported as 'Net interest income'			
- Interest income	<b>12,687</b>	11,334	12,279
- Interest expense	<b>(1,933 )</b>	(1,629 )	(1,742 )
- Net interest income	<b>10,754</b>	9,705	10,537
Net interest income and expense reported as 'Net trading income'	<b>(1,085 )</b>	(770 )	(927 )
Net interest income and expense reported as 'Net income from financial instruments designated at fair value'	<b>2</b>	34	25
Average interest-earning assets	<b>986,694</b>	944,273	957,970
Net interest spread	<b>2.09 %</b>	1.98 %	2.09 %
Net interest margin	<b>2.20 %</b>	2.07 %	2.18 %

**Net fee income increased by HK\$126m, or 4.3%, to HK\$3,062m when compared with the first half of 2013.**

Retail investment funds income increased by 5.4%, benefiting from increased funds sale volumes.

Insurance-related fee income rose by 11.7%, reflecting growth in life re-insurance commission income as a result of the successful sale of the life insurance product – Prosper Dragon Life Insurance Plan – as well as the distribution commission from non-life insurance products during the period.

Card services income was 3.4% higher than the first half of 2013, in line with the growth in average card balances. The Bank's effective customer loyalty scheme and card utilisation promotions helped drive up the Bank's card spending. The growth in card income was also supported by the increase of 9.3% in cardholder spending and a 3.3% increase in the number of cards in circulation as well as a 7.7% increase in merchant acquiring business.

Credit facilities fee income rose by 13.5%, due mainly to higher fees from increased corporate lending.

Fees from remittances recorded encouraging growth of 22.2%, underpinned by increased business volumes as a result of the expansion of Renminbi cross-border trade settlement volumes.

Stockbroking and related services income fell by 4.5%, as a result of subdued stock market trading activity. Trade-related service income was down by 8.5%.

Compared with the second half of 2013, net fee income increased by 3.8%, primarily from higher retail investment funds income.

**Net trading income decreased by HK\$143m, or 11.9%, to HK\$1,061m when compared with first half of 2013.**

Dealing profits fell by HK\$148m, or 12.2%, to HK\$1,067m. Foreign exchange income was lower, affected by subdued customer activity levels as market volatility was low. Income from foreign exchange option-linked structured products dropped, with reduced arbitrage opportunities during the second quarter reducing customer appetite for renminbi-denominated products. However, these unfavourable factors were offset by higher net interest income from funding swaps<sup>†</sup> activities.

Income from securities, derivatives and other trading activities recorded a net gain of HK\$72m, up HK\$47m, when compared with the same period last year, reflecting the combined effect of higher income on equity derivatives and the revaluation loss on equity options backing a life endowment product in first half of 2013. Debt securities recorded a revaluation gain compared with a revaluation loss for the same period last year, mainly reflecting the movement in market interest rates. These increases were offset in part by the revaluation loss on interest rate derivatives products.

*\* From time to time Treasury employs foreign exchange swaps for its funding activities, which in essence involve swapping a currency ('original currency') into another currency ('swap currency') at the spot exchange rate for short-term placement and simultaneously entering into a forward exchange contract to convert the funds back to the original currency on maturity of the placement. In accordance with HKAS 39, the exchange difference of the spot and forward contracts is required to be recognised as a foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.*

**Net income from financial instruments designated at fair value recorded a net gain of HK\$428m compared with a net loss of HK\$111m for the first half of 2013**, due mainly to favourable equity market movements during the first half of 2014. To the extent that the investment return is attributable to policyholders, there is an offsetting movement reported under 'net insurance claims incurred and movement in policyholders' liabilities' or 'movement in present value of in-force long-term insurance business ('PVIIF').

**Dividend income was broadly in line with first half of 2013 but decreased significantly from HK\$1,010m to HK\$5m when compared with the second half of 2013**, due mainly to the dividend received from Industrial Bank.

**Net earned insurance premiums increased by HK\$204m, or 3.5% while net insurance claims incurred and movement in policyholders' liabilities increased by HK\$469m, or 7.3%.**

**Other operating income rose by HK\$36m, or 3.3% compared with the first half of 2013**, driven by the increase in rental income and growth in the movement in present value of in-force long-term insurance business, partly offset by a lower revaluation gain on a property held by the insurance business. The increase in the movement in present value of in-force long-term insurance business was mainly due to new sales with a higher profit margin and a favourable change in market conditions.

#### Analysis of income from wealth management business

<i>Figures in HK\$m</i>	<i>Half-year ended 30 June 2014</i>	<i>Half-year ended 30 June 2013 (restated)</i>	<i>Half-year ended 31 December 2013</i>
Investment income:			
- retail investment funds	891	845	703
- structured investment products <sup>†</sup>	523	675	290
- stockbroking and related services	495	519	522
- margin trading and others	146	173	146
	<b>2,055</b>	<b>2,212</b>	<b>1,661</b>
Insurance income:			
- life insurance	2,043	1,722	1,757
- general insurance and others	116	105	102
	<b>2,159</b>	<b>1,827</b>	<b>1,859</b>
<b>Total</b>	<b>4,214</b>	<b>4,039</b>	<b>3,520</b>

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

Wealth management business income maintained good growth momentum in the first half of 2014, achieving a 4.3% increase when compared with the same period last year. Investment income declined by 7.1%, mainly affected by weaker investor sentiment in the second quarter of 2014, as reflected by slower fund sales and securities broking activities. Insurance business income grew by 18.2%, due mainly to our proactive management of the life insurance investment portfolio which resulted in an increase of HK\$390m in investment gains when compared with the same period last year. Compared with the second half of 2013, wealth management business income grew by 19.7%, driven by the increase of 23.7% in investment income and 16.1% in insurance income.

#### Analysis of insurance business income

<i>Figures in HK\$m</i>	<i>Half-year ended 30 June 2014</i>	<i>Half-year ended 30 June 2013</i>	<i>Half-year ended 31 December 2013</i>
Life insurance:			
- net interest income and fee income	1,517	1,506	1,527
- returns on life insurance investment portfolios (including share of associate's profit and surplus on property revaluation backing insurance contracts)	604	214	806
- net earned insurance premiums	6,004	5,800	4,205
- net insurance claims incurred and movement in policyholders' liabilities	(6,889)	(6,420)	(5,354)
- movement in present value of in-force long-term insurance business	807	622	573
	2,043	1,722	1,757
General insurance and others	116	105	102
Total	2,159	1,827	1,859

Against a backdrop of weakening investment sentiment, our comprehensive range of life insurance products underpinned the wealth management income stream. Life insurance income achieved growth of HK\$321m, or 18.6%, to HK\$2,043m, reflecting the improvement in the life insurance investment portfolios return and the growth of business.

Supported by our diversified range of life insurance products, the Bank achieved a 4.4% increase in new annualised life insurance premiums when compared with the first half of 2013. To better meet the needs of customers at different life stages, the Bank has entered into an exclusive 10-year distribution agreement with international healthcare company Bupa in providing medical insurance products and services.

Net interest income and fee income from the life insurance investment portfolio grew by 0.7% as the Bank has re-balanced assets under the low interest rate environment. Investment returns on life insurance grew strongly by 182.2%, benefiting from the favourable movement in equity markets, though partly offset by lower property revaluation gains. To the extent that the investment return is attributable to policyholders, there is an offsetting movement reported under 'net insurance claims incurred and movement in policyholders' liabilities' or 'movement in present value of in-force long-term insurance business ('PVIF')'. Net earned insurance premiums rose by 3.5% as a result of increased renewals of existing policies, partly offset by lower new business premiums written. The growth in insurance premiums earned resulted in a corresponding increase in 'net insurance claims incurred and movement in policyholders' liabilities'. The increase in the movement in present value of in-force long-term insurance business was driven by new sales with a higher profit margin and a favourable change in market conditions.

General insurance income increased by 10.5%, reflecting higher distribution commission income.

**Loan impairment charges and other credit risk provisions increased by HK\$139m**, or 70.2%, when compared with first half of last year, but were at the same level compared with the second half.

<i>Figures in HK\$m</i>	<i>Half-year ended 30 June 2014</i>	<i>Half-year ended 30 June 2013</i>	<i>Half-year ended 31 December 2013</i>
Net charge for impairment of loans and advances to customers:			
Individually assessed impairment allowances:			
- new allowances	(179)	(61)	(130)
- releases	91	57	34
- recoveries	31	7	9
	<u>(57)</u>	<u>3</u>	<u>(87)</u>
Net charge for collectively assessed impairment allowances	(252)	(201)	(251)
Other credit risk provisions	<u>(28)</u>	<u>—</u>	<u>—</u>
Loan impairment charges and other credit risk provisions	<u><b>(337)</b></u>	<u><b>(198)</b></u>	<u><b>(338)</b></u>

Individually assessed impairment charges increased from a low base of a HK\$3m net release to a HK\$57m net charge, due to the downgrade of a few corporate and commercial customers of Hang Seng China, partly offset by higher releases and recoveries from corporate and commercial customers in the first half of 2014.

Collectively assessed charges increased by HK\$51m, or 25.4%, when compared with the first half of 2013. Impairment allowances for loans not individually identified as impaired recorded a lower release compared with the first half of 2013 as a result of the increase in customer loan balances and updated assumptions in the assessment model. Impairment charges for credit card and personal loan portfolios decreased, reflecting the revision to the collective impairment models in the first half of 2013.

Overall credit quality was relatively stable with total loan impairment allowances as a percentage of gross advances lowered to 0.23% when compared with 0.25% at last year-end. The Group remains cautious on the credit outlook.

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

	<i>At 30 June 2014</i>	<i>At 30 June 2013</i>	<i>At 31 December 2013</i>
	%	%	%
Loan impairment allowances:			
- individually assessed	0.11	0.11	0.12
- collectively assessed	0.12	0.12	0.13
Total loan impairment allowances	<u><b>0.23</b></u>	<u><b>0.23</b></u>	<u><b>0.25</b></u>

**Operating expenses increased by HK\$295m, or 6.8%, compared with the first half of 2013**, reflecting the Bank's continued investment in new business platforms and Mainland operations to support long-term business growth and capture business opportunities while continuing carefully to manage costs. Mainland-related operating expenses increased by 6.9% due to ongoing investment in enhancing Hang Seng China's infrastructure and service capabilities. Compared with the second half of 2013, operating expenses fell by HK\$118m, or 2.5%.

Employee compensation and benefits increased by HK\$125m, or 5.8%. Salaries and other costs increased by 6.0%, reflecting the annual salary increment and performance related remuneration. General and administrative expenses were up 8.2%, due mainly to the rise in marketing expenditure to support business growth. Rental expenses rose as a result of increased rents for branches in Hong Kong and on the Mainland. Other operating expenses also increased as a result of higher processing charges. Depreciation charges were up 8.0%, reflecting higher depreciation charges on business premises following the upward commercial property revaluation in Hong Kong.

<i>Full-time equivalent staff numbers by region</i>	<i>At 30 June 2014</i>	<i>At 30 June 2013</i>	<i>At 31 December 2013</i>
Hong Kong and others	<b>7,894</b>	8,014	8,001
Mainland	<b>1,769</b>	1,820	1,855
Total	<b>9,663</b>	9,834	9,856

At 30 June 2014, the Group's number of full-time equivalent staff was down by 193 compared with the end of 2013.

The Bank continued to focus on enhancing operational efficiency while maintaining growth momentum. With the increase in net operating income before loan impairment charges outpacing the growth in operating expenses, the cost efficiency ratio lowered by 0.1 percentage points to 32.1%.

**Operating profit grew by HK\$562m, or 6.3%, to HK\$9,496m**, after accounting for the increase of HK\$139m in **loan impairment charges and other credit risk provisions**, reflecting a broad-based increase in core banking business income.

**Profit before tax decreased by 47.4% to HK\$9,877m** after taking the following major items into account:

- the non-recurrence of the gain of HK\$8,454m on **the reclassification of Industrial Bank** in January 2013;
- a HK\$178m decrease in **gains less losses from financial investments and fixed assets**, due mainly to property disposals in the first half of 2013;
- a 77.0% (or HK\$769m) decrease in **net surplus on property revaluation**; and
- a 26.8% (or HK\$57m) decrease in **share of profits from associates**, mainly due to the reclassification of Yantai Bank in December 2013.

**Net surplus on property revaluation decreased by 77.0% to HK\$230m when compared with the first half of 2013.**

<i>Figures in HK\$m</i>	<i>Half-year ended 30 June 2014</i>	<i>Half-year ended 30 June 2013</i>	<i>Half-year ended 31 December 2013</i>
Surplus of revaluation on investment properties	<b>230</b>	866	192
Surplus/(deficit) of revaluation on assets held for sale	—	136	(3)
Revaluation deficit on premises	—	(3)	—
	<b>230</b>	<b>999</b>	<b>189</b>

The Group's premises and investment properties were revalued at 30 June 2014 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of property was market value which is consistent with the definition of fair value under HKFRS 13 'Fair Value Measurement' and takes into account the highest and best use of the property from the perspective of market participants. The highest and best use takes into account the use of the property that is physically possible, legally permissible and financially feasible as described in HKFRS 13. The net revaluation surplus for Group premises amounted to HK\$612m was credited to the premises revaluation reserve. The related deferred tax provision for Group premises was HK\$103m. Revaluation gains of HK\$230m on investment properties (excluding the revaluation gain on properties backing insurance contracts) were recognised through the income statement.

The revaluation exercise also covered business premises and investment properties reclassified as properties held for sale. There was no revaluation gain recognised through the income statement during the period.

## Segmental Analysis

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

<i>Figures in HK\$m</i>	<i>Hong Kong &amp; other businesses</i>						<i>Total</i>
	<i>Retail Banking and Wealth Management</i>	<i>Commercial Banking</i>	<i>Global Banking and Markets</i>	<i>Other</i>	<i>Total</i>	<i>Mainland China business</i>	
<i>Half-year ended 30 June 2014</i>							
Profit before tax	<u>4,652</u>	<u>2,489</u>	<u>2,179</u>	<u>395</u>	<u>9,715</u>	<u>162</u>	<u>9,877</u>
Share of profit before tax	<u>47.1 %</u>	<u>25.2 %</u>	<u>22.1 %</u>	<u>4.0 %</u>	<u>98.4 %</u>	<u>1.6 %</u>	<u>100.0 %</u>
Share of profit before tax as a % of Hong Kong & other businesses	<u>47.9 %</u>	<u>25.6 %</u>	<u>22.4 %</u>	<u>4.1 %</u>	<u>100.0 %</u>		
<i>Half-year ended 30 June 2013 (restated)</i>							
Profit before tax	<u>4,455</u>	<u>2,423</u>	<u>2,037</u>	<u>1,225</u>	<u>10,140</u>	<u>8,633</u>	<u>18,773</u>
Share of profit before tax	<u>23.8 %</u>	<u>12.9 %</u>	<u>10.8 %</u>	<u>6.5 %</u>	<u>54.0 %</u>	<u>46.0 %</u>	<u>100.0 %</u>
Share of profit before tax as a % of Hong Kong & other businesses	<u>43.9 %</u>	<u>23.9 %</u>	<u>20.1 %</u>	<u>12.1 %</u>	<u>100.0 %</u>		
<i>Half-year ended 31 December 2013 (restated)</i>							
Profit before tax	<u>4,484</u>	<u>2,211</u>	<u>2,033</u>	<u>1,159</u>	<u>9,887</u>	<u>(164)</u>	<u>9,723</u>
Share of profit before tax	<u>46.1 %</u>	<u>22.7 %</u>	<u>20.9 %</u>	<u>12.0 %</u>	<u>101.7 %</u>	<u>(1.7 %)</u>	<u>100.0 %</u>
Share of profit before tax as a % of Hong Kong & other businesses	<u>45.4 %</u>	<u>22.4 %</u>	<u>20.6 %</u>	<u>11.6 %</u>	<u>100.0 %</u>		

**Retail Banking and Wealth Management ('RBWM')** in Hong Kong reported profit before tax of HK\$4,652m in the first half of 2014, a 4.4% increase compared with the first half of 2013. Operating profit excluding loan impairment charges reached HK\$4,744m, an increase of 3.7%. Operating profit grew by 4.7% to HK\$4,497m.

Net interest income was maintained at HK\$4,888m, in line with the first half of 2013, despite downward pressure on deposit margin as a result of increased competition and moderate growth in mortgage lending.

Non-interest income grew strongly by 14.7% to HK\$2,606m, reflecting a growth in net fee income and trading income as well as an improvement in net income from financial instruments at fair value whereas a loss was recorded in the first half of 2013. We sustained our momentum in wealth management business, with income growing by 10.7% to HK\$3,495m.

Unsecured lending business continued to be a key growth driver. Supported by effective marketing campaigns and a good quality credit card customer base, card spending achieved year-on-year growth of 9.4%. Total cards in circulation rose by 3.2% to 2.48 million year-on-year and we were the third largest card issuer of VISA and MasterCard in the first half of 2014. We were able to reach more targeted customers from our existing customer base to grow our personal loan portfolios. Compared to last year-end, the personal loan portfolio rose by 11.7%.

Our mortgage business maintained third position in the market, with a market share of 16.2% in terms of new mortgage registrations. Mortgage balances grew by 2.1% compared to 2013 year-end.

Investment funds income rose year-on-year by 6.2% with turnover increasing by 9.4% compared with last year. However, reduced transaction turnover in the stock market impacted our securities business. Securities turnover and income recorded reductions of 6.4% and 4.0% respectively.

Total operating income for insurance business achieved growth of 19.0%, reflecting an improvement in investment portfolio return and our effective distribution effort. Supported by the initiative to broaden our protection plans offerings, we diversified the life insurance product mix to create higher business value. In addition, we have entered into an exclusive 10 year distribution agreement with international healthcare company Bupa in providing medical insurance products and services.

With multiple efforts in strengthening Prestige and Preferred propositions and China connectivity, Prestige and Preferred Banking customers grew 7.0% year-on-year. We launched an awareness campaign to communicate our enhanced customer propositions and product features based on customer's wealth management needs. We accelerated our pace in the development of Prestige and Preferred Banking Centres to enhance customer experience. During the first half of 2014, five more Prestige and Preferred Banking Centres were established in strategic locations, bringing a total of 17 centres in our portfolio.

We continued to drive sustainable business growth with environmentally friendly initiatives. We deployed the e-signature pads at our branches to facilitate an efficient and paperless transactions environment. Efforts were also made to encourage customers to adopt the e-statement / e-advice services, with over half of our e-Banking customers utilising the services in the first half of 2014. Furthermore, we enhanced our capabilities to support paperless billing process through the Electronic Bill Presentation and Payment (EBPP) platform.

**Commercial Banking ('CMB')** in Hong Kong reported a 2.7% increase in profit before tax to HK\$2,489m. Operating profit excluding loan impairment charges grew by 4.8% to HK\$2,476m. Operating profit grew by 2.7% to HK\$2,488m.

Net interest income increased by 11.0% to HK\$2,228m, supported by balanced growth in both customer advances and deposits compared with last year-end. Customer advances increased by 13.2% with targeted marketing and cross-border collaborations leading to diversified growth in different industry sectors. Deposits increased by 9.2%, driven by continuing acquisition of quality Mainland customers and propositions targeting professional firms, listed companies, property developers and retailers.

Non-interest income decreased by 2.9% to HK\$1,109m, primarily because customers have reduced renminbi hedging activities with the depreciation of renminbi and our strategic repositioning of trade finance business to support the needs of core corporate customers.

Remittance income grew by 21.9% year-on-year, underpinned by cross-border business collaboration and initiatives.

Insurance income rose by 12.9% comparing with the first half of 2013, reflecting balanced growth in key-person and general insurance businesses. We strengthened our collaboration with QBE Insurance, resulting in good growth in general insurance income. Increased penetration of the SME sector led to a 16.1% increase in life insurance income.

We maintained good asset quality and recorded a net release in loan impairment charges as a result of proactive credit risk management and improved post-approval monitoring of loan assets. We continued to enhance our portfolio management to improve overall returns on risk assets.

We maintained our strong position for syndicated lending. According to Thomson Reuters LPC data, we ranked second and third in the Mandated Arranger and Bookrunner League Tables respectively for Hong Kong and Macau Syndicated Loans in terms of number of transactions in the first half of 2014.

We continued to tap cross-border business opportunities. We successfully completed the first renminbi cross-border loan to a customer in the Shanghai Free Trade Zone in the first half of 2014.



We have enriched our service propositions and enhanced our Business Banking Centres network to attract and retain quality SME customers. Mainland companies continued to be one of our targeted segments, representing 44.9% of newly acquired SME customers in the first half. New customers were the primary drivers of growth in SME customer deposits and the 9.5% increase in non-interest income from SME business.

Our SME banking services continued to receive independent recognition. For the ninth consecutive year, Hang Seng Bank has received the SME's Best Partner Award from the Hong Kong General Chamber of Small & Medium Business.

**Global Banking and Markets ('GBM')** in Hong Kong recorded a 7.0% increase in profit before tax to HK\$2,179m. Operating profit excluding loan impairment charges grew by 7.2% to HK\$2,176m. Operating profit rose 6.9% to HK\$2,176m.

**Global Banking ('GB')** in Hong Kong achieved a 14.5% increase in profit before tax to HK\$821m. Operating profit excluding loan impairment charges grew by 15.4% to HK\$819m. Operating profit grew 14.4% to HK\$819m.

Net interest income rose by 13.9% to HK\$813m, driven primarily by good loan growth, whilst maintaining strong credit quality. At the same time, we maintained robust credit risk management. Customer deposits increased by 41.6% compared with last year-end as we stepped up our marketing efforts to acquire more new deposits and offer payment and cash management solutions to grow account balances.

Non-interest income recorded strong growth of 25.3% mainly due to increased transactional banking business.

To drive business opportunities in mainland China and Hong Kong, GB will continue to work closely with Hang Seng China in promoting renminbi related services including deposit, loan and trade finance to take advantage of the liberalisation of renminbi business and opportunities arising from the development of new economic zones in Qianhai and Hengqin as well as the Shanghai Free Trade Zone.

**Global Markets ('GM')** in Hong Kong recorded a 2.9% increase in profit before tax to HK\$1,358m. Operating profit excluding loan impairment charges grew by 2.8% to HK\$1,357m. Operating profit increased by 2.8% to HK\$1,357m.

Net interest income increased by 19.8% to HK\$951m. The balance sheet management team has been actively managing the interest rate risk and assessing different market opportunities for better yield enhancement of the commercial surplus.

Non-interest income decreased by HK\$97m to HK\$580m. Total trading income decreased by HK\$111m, or 16.1%, to HK\$579m. Foreign exchange trading income decreased due to lower market volatility. Income from structured products was also impacted by reduced customer demand for renminbi products due to the depreciation of the renminbi.

Front-line channels (including e-Banking) and trading systems were enhanced to facilitate straight-through processing, enabling better position management. To support client clearing directly and strengthen market standing as a leading local bank, the Bank will join OTC Clearing Hong Kong Limited as a direct member for central clearing of its over-the-counter derivatives in 2014.

To diversify revenue sources, GM has increased cross-selling of Global Markets products to RBWM and CMB customers. Strategic actions were set for identifying RBWM and CMB customer needs and cross-selling opportunities through collaboration schemes.

Going forward, GM will continue to position itself to capture yield enhancement opportunities by investing in Hong Kong and Mainland bonds and capturing yield curves of selected currencies. As the renminbi market in Hong Kong evolves, GM will continue to develop renminbi-denominated hedging and investment products to meet customer needs as well as explore new business opportunities for cross-selling treasury products with other customer groups.

## Mainland China business

The operating results of Hang Seng China improved in the first half of 2014. Operating profit excluding loan impairment charges and other credit risk provisions grew by 136.6%, mainly from the 33.4% increase in net interest income. Solid progress with expanding trade-related business and treasury product sales drove 35.9% growth in net fee and commission income. Trading income declined, reflecting the impact of market interest rate changes on the fair value of structured deposits. Overall, non-interest income fell by 11.6%. Operating profit increased by 26.4%, reflecting higher impairment charges in the first half of 2014 compared with a net release in same period last year. Asset quality remains stable with impaired loan ratios at 0.42% at the end of 30 June 2014. Profit before tax decreased by 98.1% when compared with the first half of 2013, which benefited from the HK\$8,454m accounting gain on the reclassification of Industrial Bank and a HK\$52m share of profit from Yantai Bank. Excluding these items, profit before tax rose by 27.6%.

Backed by enhanced cross-border collaboration, Hang Seng China achieved a 5.8% rise in customer deposits compared to 2013 year-end. In June, Hang Seng China successfully raised RMB1bn in Hong Kong through its debut offshore renminbi bond issue with positive response from a diverse group of investors. Lending grew by 1.9% with continuing emphasis on sound credit risk management.

	<i>As reported</i>	<i>Constant currency<sup>†</sup></i>
<b><i>Half-year ended 30 June 2014 compared with 30 June 2013</i></b>		
Total operating income	<b>25.1 %</b>	<b>23.1 %</b>
Operating profit excluding loan impairment charges and other credit risk provisions	<b>136.6 %</b>	<b>134.5 %</b>
Operating profit	<b>26.4 %</b>	<b>24.4 %</b>
Profit before tax	<b>-98.1 %</b>	<b>n.a</b>
<b><i>At 30 June 2014 compared with 31 December 2013</i></b>		
Gross loans and advances to customers	<b>1.9 %</b>	<b>3.7 %</b>
Customer deposits and debt securities in issue	<b>5.8 %</b>	<b>7.7 %</b>

Given the growing economic ties between Hong Kong and the Mainland, Hang Seng China has enhanced the cooperation and connectivity with Hang Seng Hong Kong, aiming to create more synergy and to seize new opportunities. In this regard, the Shanghai Free Trade Zone Sub-branch was opened in February 2014 to provide the latest available solutions to our clients. In April, the Greater China Prestige programme was launched to serve clients with banking needs in both mainland China and Hong Kong. Hang Seng China will continue to capture opportunities generated by increasing cross-border economic integration and renminbi internationalisation.

The Chengdu Branch was also opened in February to serve and develop our clients in the fast growing central and western region to supplement our coverage in the Pearl River Delta, Yangtze River Delta and Bohai Rim. Meanwhile, Hang Seng China continues to invest in direct channels including call centres, e-Banking and SMS services to enhance our customers' experience.

<sup>†</sup> Constant currency comparatives for 2013 referred to in the tables above are computed by translating into Hong Kong dollars the functional currency (renminbi) of Hang Seng's mainland China business:

- the income statement for the half year to 30 June 2013 at the average rates of exchange for the half year to 30 June 2014; and

- the balance sheet at 31 December 2013 at the prevailing rates of exchange on 30 June 2014.

## Balance Sheet

**Total assets** grew by HK\$52.2bn, or 4.6%, to HK\$1,196.0bn when compared with the year-end, reflecting the Group's balanced growth strategy to enhance profitability. Customer loans and advances increased by HK\$46.7bn, or 8.0%, to HK\$632.9bn, largely through growth in corporate and commercial lending. Amidst lower property market turnover, we maintained our market share in underwriting new mortgage business. Residential mortgage lending increased by 2.4% when compared with the year-end. Hang Seng China lending portfolios increased by 1.9%, mainly to corporate customers. Overall loan quality remained sound with total loan impairment allowances as a percentage of gross loans and advances to customers improving to 0.23% at 30 June 2014. Customer deposits, including certificates of deposit and other debt securities in issue, rose by HK\$51.1bn, or 5.9%, to HK\$920.8bn. In June, Hang Seng China successfully raised RMB1bn in Hong Kong through its debut offshore renminbi bond issue with positive response from a diverse group of investors. At 30 June 2014, the advances-to-deposits ratio was 68.7%, compared with 67.4% at 31 December 2013.

### Loans and advances to customers

Gross loans and advances to customers grew by HK\$46.7bn, or 8.0%, to HK\$634.4bn compared with the end of 2013.

Loans and advances for use in Hong Kong increased by HK\$39.8bn, or 10.0%. Lending to the industrial, commercial and financial sectors grew by 15.2%. Lending to property development and property investment increased by 37.6% and 10.5% respectively. Lending to stockbrokers grew by HK\$2.6bn mainly from financing granted to stockbroking companies relating to several initial public offerings at the end of June 2014. The Bank's continued efforts to support local business saw lending to wholesale and retail trade and manufacturing sectors grew by 14.0% and 19.8% respectively.

Lending to individuals increased by 3.6% compared with the last year-end. The Bank was able to maintain its market share for the mortgage business based on comprehensive product suite and thus residential mortgage lending to individuals rose by 2.4% compared with the end of 2013. Credit card advances were broadly at the same level as last year-end. Other loans to individuals grew by 19.6%, reflecting the success of the Bank in expanding its consumer finance business.

Loans and advances for use outside Hong Kong rose by 5.4%, compared with the end of 2013, driven largely by lending on the Mainland. Lending by Hang Seng China increased by 1.9% to HK\$62.3bn, underpinned by the expansion of renminbi lending to corporate and commercial customers as well as residential mortgages. The Group employed a cautious approach to lending on the Mainland and will continue to strengthen its prudent credit policies in light of the more difficult operating conditions for Mainland businesses.

### Customer deposits

Customer deposits, including current, savings and other deposits accounts, certificates of deposit and other debt securities in issue recorded growth of 5.9% to HK\$920.8bn at 30 June 2014 from last year-end. Structured deposits, certificates of deposit and other debt securities in issue increased as instruments with yield enhancement features gained popularity. Deposits with Hang Seng China also rose by 5.8%, driven mainly by renminbi deposits. In June, Hang Seng China successfully raised RMB1bn in Hong Kong through its debut offshore renminbi bond issue with a positive response from a diverse group of investors.

At 30 June 2014, the advances-to-deposits ratio was 68.7%, compared with 67.4% at 31 December 2013.

## **Equity**

At 30 June 2014, shareholders' funds (excluding proposed dividends) were HK\$107.4bn, an increase of HK\$3.8bn, or 3.7%, against last year-end. Retained profits grew by HK\$4.5bn, resulting from the growth in attributable profit after the appropriation of interim dividends. The premises revaluation reserve increased by HK\$296m, or 2.0%, reflecting an increase in the fair value of the Bank's premises. The available-for-sale investment reserve recorded a revaluation deficit of HK\$2,460m, compared with a deficit of HK\$1,618m at the end of 2013, primarily reflecting the unrealised revaluation deficit on the Bank's investment in Industrial Bank. Available-for-sale financial investments are tested for impairment when there is an indication that the investment may be impaired. The Group's policy is to recognise an impairment loss where there is a 'significant' or 'prolonged' decline in the fair value of an equity investment.

## Risk and Capital Management

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

### Risk Management

All the Group's activities involve the analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The principal types of risk faced by the Group are credit risk, liquidity risk, market risk, insurance risk, operational risk and reputational risk. There have been no material changes to our policies and practices regarding risk management and governance as described in the Group's Annual Report 2013.

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

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

Risk appetite statement is a key component of risk management framework. The Group's Risk Appetite Statement for 2014 was approved by the Board as advised by the Risk Committee, which describes the types and amount of risk that the Bank is prepared to accept in executing our business strategy.

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

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

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

For new products and services, in addition to the existing due diligence process, a Product Oversight Committee reporting to the RMC and comprising senior executives from Risk, Legal, Compliance, Finance, and Operations/IT, is responsible for reviewing and approving the launch of such new products and services. Each new service and product launch is also subject to an operational risk self-assessment process, which includes identification, evaluation and mitigation of risk arising from the new initiative. Internal Audit is consulted on the internal control aspect of new products and services in development prior to implementation.

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

#### (a) Credit Risk

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, and treasury businesses. The Group has dedicated standards, policies and procedures in place to control and monitor risk from all such activities.

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

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

## Risk and Capital Management (continued)

### Risk Management (continued)

#### (a) Credit Risk (continued)

##### Impaired loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loan impairment allowances are made promptly where necessary and need to be consistent with established guidelines. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Management regularly performs an assessment of the adequacy of the established impairment provisions by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions.

##### Risk rating framework

A sophisticated risk rating framework on counterparty credit risk based on default probability and loss estimates is implemented across the Group. The rating methodology of this framework is based upon a wide range of financial analytics. This approach will allow a more granular analysis of risk and trends. The information generated from the risk rating framework is mainly, but not exclusively, applied to credit approval, credit monitoring, pricing, loan classification and capital adequacy assessment. The Group also has control mechanisms in place to validate the performance and accuracy of the risk rating framework.

To measure and manage the risk in these exposures, both to individually assessed customers and to those aggregated into portfolios, the Group employs diverse risk rating systems and methodologies.

##### Collateral and other credit enhancements

The Group has implemented guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determined the valuation parameters. Such parameters are established prudently and are reviewed regularly in light of changing market environment and empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfill their intended purpose and remain in line with local market practice. While collateral is an important mitigant to credit risk, it is the Group's policy to establish that loans are within the customer's capacity to repay rather than to rely excessively on security. Facilities may be granted on unsecured basis depending on the customer's standing and the type of product. The principal collateral types are as follows:

- in the personal sector, charges over the properties, securities, investment funds and deposits;
- in the commercial and industrial sector, charges over business assets such as properties, stock, debtors, investment funds, deposits and machinery; and
- in the commercial real estate sector, charges over the properties being financed.

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

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

##### Settlement risk

Settlement risk arises where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily Settlement Limits are established to cover the settlement risk arising from the Group's trading transactions on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated when effected via assured payment systems, or on a delivery-versus-payment basis.

The International Swaps and Derivatives Association ("ISDA") Master Agreement is the Group's preferred agreement for documenting derivative activities. It provides the contractual framework that a full range of over-the-counter ("OTC") products is conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement, if either party defaults or following other pre-agreed termination events.

##### Concentration of credit risk

Concentration of credit risk exists when changes in geographic, economic or industry factors similarly affect groups of counterparties whose aggregate credit exposure is material in relation to the Group's total exposures. The Group's portfolio of financial instrument is diversified along geographic, industry and product sectors. Analysis of geographical concentration of the Group's assets is disclosed in note 17 to the financial statements and credit risk concentration of respective financial assets is disclosed in notes 21, 22, 24 and 25.

#### (i) Maximum exposure to credit risk before collateral held or other credit enhancements

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Cash and balances at central banks	7,721	9,798	22,717
Placings with and advances to banks	142,975	141,012	141,940
Trading assets	26,178	34,484	31,968
Financial assets designated at fair value	60	4,228	812
Derivative financial instruments	6,296	4,752	6,646
Loans and advances to customers	632,947	579,705	586,240
Financial investments	270,407	237,223	254,849
Other assets	20,457	16,641	16,483
Financial guarantees and other credit related contingent liabilities	22,737	16,906	18,970
Loan commitments and other credit related commitments	460,243	422,296	394,080
	<b>1,590,021</b>	<b>1,467,045</b>	<b>1,474,705</b>

## **Risk and Capital Management** *(continued)*

### **Risk Management** *(continued)*

#### **(a) Credit Risk** *(continued)*

##### **(ii) Credit quality**

A summary of the four classifications and risk rating scales describing the credit quality of the Group's lending and debt securities portfolios are provided on page 47 of the Annual Report 2013.

#### ***Impaired loans and advances***

Special attention is paid to problem loans and appropriate action is initiated to protect the Group's position on a timely basis and to ensure that loan impairment methodologies result in losses being recognised when they are incurred.

The Group's policy for recognising and measuring impairment allowances on both individually assessed advances and those which are collectively assessed on a portfolio basis is described in note 3(d) to the financial statements for the year ended 31 December 2013.

Analysis of impairment allowances at 30 June 2014 and the movement of such allowances during the year are disclosed in note 24 to the financial statements.

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

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

- retail loans and advances:

- classified as EL 9 or EL 10;

- classified as EL 1 to EL 8 with 90 days and over past due;

- that have been with either 90 days and over past due or with economic loss incurred by the Group irrespective of the delinquency status; or

- 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.

#### ***Impairment assessment***

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

For details of our impairment policies on loans and advances and financial investments, see notes 3(d) and 3(s) on the financial statements for the year ended 31 December 2013.

#### **Impairment and credit risk mitigation**

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

Personal lending portfolios are generally assessed for impairment on a collective basis as the portfolios typically consist of large groups of homogeneous loans. Two methods are used to calculate allowances on a collective basis: a roll rate methodology or a more basic formulaic approach based on historical losses. For the period end 30 June 2014, we reviewed the impairment allowance methodology used for retail banking and small business portfolios across the Group to ensure that the assumptions used in our collective assessment models continue to appropriately reflect the period of time between a loss event occurring and the account proceeding to delinquency and eventual write-off.

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

A roll rate methodology is more commonly adopted for unsecured portfolios when there are sufficient volumes of empirical data to develop robust statistical models.

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

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

## **Risk and Capital Management** *(continued)*

### **Risk Management** *(continued)*

#### **(b) Liquidity and funding risk**

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

As part of our Asset, Liability and Capital Management structure, we have established Asset and Liability Management Committee ("ALCO") at Group level and in major operating entities. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding. Management of liquidity is carried out both at Group and Bank levels as well as in individual branches and subsidiaries. The Group requires branches and subsidiaries to maintain a strong liquidity position and to manage the liquidity structure of their assets, liabilities and commitments so that cash flows are approximately balanced and all funding obligations are met when due.

It is the responsibility of the Group's management to ensure compliance with local regulatory requirements and limits set by ALCO. Liquidity is managed on a daily basis by the Bank's treasury functions and overseas treasury sites.

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

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

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

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

- maintaining compliance with relevant regulatory requirements of the reporting entity;
- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to core funding ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined limits;
- managing debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and contingency funding 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.



## **Risk and Capital Management** *(continued)*

### **Risk Management** *(continued)*

#### **(b) Liquidity and funding risk** *(continued)*

##### **The management of liquidity and funding risk**

###### *Inherent liquidity risk categorisation*

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

###### *Core deposits*

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

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

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

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

###### *Advances to core funding ratio*

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

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

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

## Risk and Capital Management (continued)

### Risk Management (continued)

#### (b) Liquidity and funding risk (continued)

##### Stressed coverage ratio

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

The stressed cash inflows include:

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

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

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

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

	Advances to core funding ratio		
	At 30 June 2014 %	At 30 June 2013 %	At 31 December 2013 %
Period-end	87.3	86.9	83.9
Maximum	88.8	86.9	86.9
Minimum	84.5	82.0	82.0
Average	86.2	83.6	84.3

	Stressed one month covering ratio		
	At 30 June 2014 %	At 30 June 2013 %	At 31 December 2013 %
Period-end	138.6	136.0	147.6
Maximum	148.7	155.6	155.6
Minimum	137.6	136.0	136.0
Average	142.2	147.0	146.8

	Stressed three month covering ratio		
	At 30 June 2014 %	At 30 June 2013 %	At 31 December 2013 %
Period-end	139.0	135.9	148.1
Maximum	145.6	150.2	150.2
Minimum	135.1	135.9	135.9
Average	139.7	145.2	145.3

## Risk and Capital Management (continued)

### Risk Management (continued)

#### (b) Liquidity and funding risk (continued)

##### Stressed scenario analysis

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

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

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

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

##### Liquid assets

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

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

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

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

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

## Risk and Capital Management *(continued)*

### Risk Management *(continued)*

#### (b) Liquidity and funding risk *(continued)*

Liquid assets of the Group

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Level 1	164,301	130,128	140,964
Level 2	17,966	16,264	19,825
Level 3	3,139	2,747	3,296
	<u>185,406</u>	<u>149,139</u>	<u>164,085</u>

All assets held within the liquid asset portfolio are unencumbered.

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

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

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

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

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

#### *Wholesale debt monitoring*

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

#### **Sources of funding**

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

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

## Risk and Capital Management (continued)

### Risk Management (continued)

#### (b) Liquidity and funding risk (continued)

##### *Liquidity behaviouralisation*

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

##### *Contingent liquidity risk*

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

##### *Contingency funding plan*

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

##### *Liquidity regulation*

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

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

The Hong Kong Monetary Authority ("HKMA") has issued a consultation paper in May 2014 on the returns for reporting of Liquidity Maintenance Ratio and liquidity monitoring tool. The HKMA has also issued three consultation papers in July 2013, June 2012 and January 2012 respectively on the implementation of Basel III Liquidity Standards in Hong Kong.

##### *Liquidity ratio under the Hong Kong Banking Ordinance*

The Hong Kong Banking Ordinance also requires banks operating in Hong Kong to maintain a minimum liquidity ratio of 25%. The average liquidity ratio for the year, calculated in accordance with the Fourth Schedule of the Hong Kong Banking Ordinance, is as follows:

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
The Bank and its subsidiaries designated by the HKMA	<u>34.5%</u>	<u>35.8%</u>	<u>33.9%</u>

## **Risk and Capital Management** *(continued)*

### **Risk Management** *(continued)*

#### **(c) Market risk**

Market risk is the risk that foreign exchange rates, interest rates, equity and commodity prices and indices will move and result in profits or losses for the Group. The objective of the Group's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the Group's status as a premier provider of financial products and services.

The Group monitors market risk exposures separately for trading and non-trading portfolios. Trading portfolios include those positions arising from market-making, customer-related business, principal position-taking and strategic foreign exchange. Non-trading portfolios primarily arise from the effective interest rate management of the Group's retail and commercial banking assets and liabilities.

The management of market risk is principally undertaken in Global Markets using risk limits approved by the Risk Management Committee ("RMC"). Limits are set for each portfolio, product and risk type, with market liquidity being a principal factor in determining the level of limits set. The Group has dedicated standards, policies and procedures in place to control and monitor the market risk. An independent market risk control function is responsible for measuring market risk exposures, monitoring and reporting these exposures against the prescribed limits on a daily basis. The market risks which arise on each business are assessed and transferred to either Global Markets for management, or to separate books managed under the supervision of Asset and Liability Management Committee ("ALCO").

#### **Value at risk ("VAR")**

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

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

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

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

Although a valuable guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a 1-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a 1-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

The Group recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures. Additionally, the Group applies a wide range of stress testing, both on individual portfolios and on the Group's consolidated positions. The Group's stress testing regime provides senior management with an assessment of the financial impact of identified extreme events on the market risk exposures of the Group.

## Risk and Capital Management (continued)

### Risk Management (continued)

#### (c) Market risk (continued)

The Group's VAR, both total and trading positions, and stressed VAR for trading positions for the periods indicated in the tables below.

	At 30 June 2014	Minimum during the year	Maximum during the year	Average for the year
<b>VAR</b>				
Total (trading and non-trading)	33	21	53	32
Total trading	8	4	11	7
Foreign exchange trading	5	1	9	4
Interest rate trading	6	3	9	5
<b>Stressed VAR</b>				
Total trading	64	23	68	40
Foreign exchange trading	10	1	32	14
Interest rate trading	79	25	83	46
	At 30 June 2013	Minimum during the year	Maximum during the year	Average for the year
<b>VAR</b>				
Total (trading and non-trading)	34	22	60	36
Total trading	12	4	14	7
Foreign exchange trading	11	3	15	6
Interest rate trading	4	3	9	5
<b>Stressed VAR</b>				
Total trading	60	14	63	34
Foreign exchange trading	26	7	35	16
Interest rate trading	44	16	64	37
	At 31 December 2013	Minimum during the year	Maximum during the year	Average for the year
<b>VAR</b>				
Total (trading and non-trading)	29	22	60	37
Total trading	4	4	17	7
Foreign exchange trading	3	2	15	6
Interest rate trading	3	3	9	4
<b>Stressed VAR</b>				
Total trading	27	14	80	33
Foreign exchange trading	13	5	48	17
Interest rate trading	37	16	82	40

## Risk and Capital Management *(continued)*

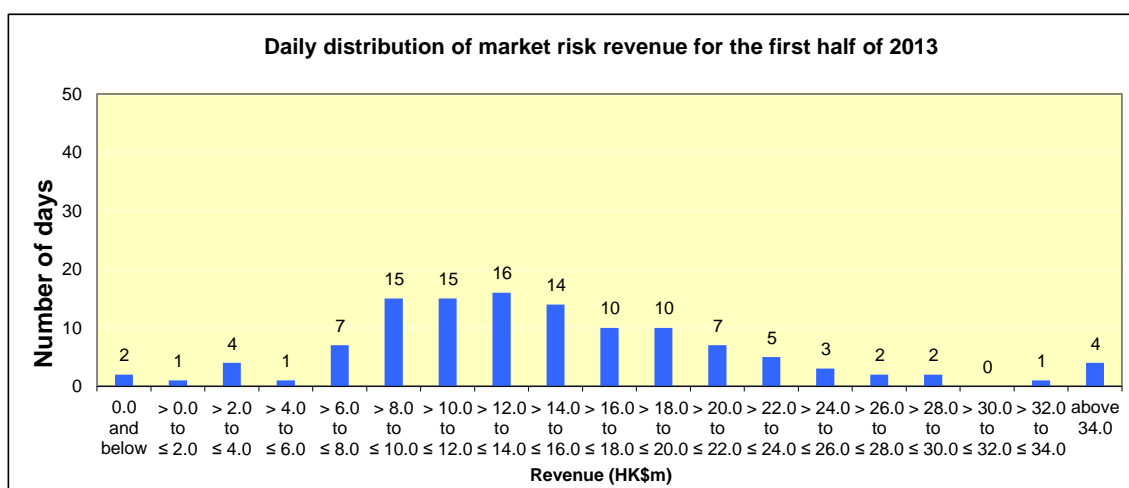
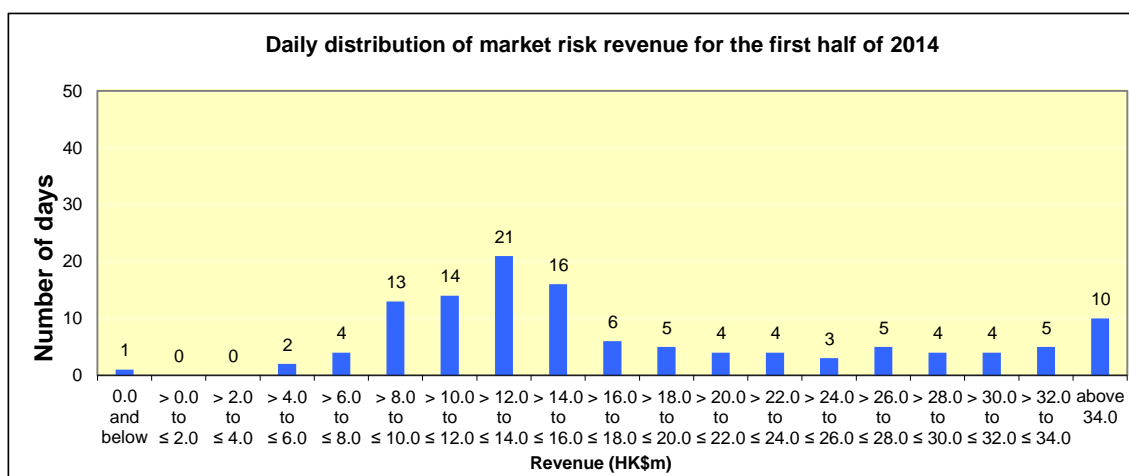
### Risk Management *(continued)*

#### (c) Market risk *(continued)*

##### Daily distribution of market risk revenues

The average daily revenue earned from market risk-related Global Markets activities for the first half of 2014, including non-trading book net interest income and funding related to trading positions, was HK\$18m (for the first half of 2013: HK\$15m). The standard deviation of these daily revenues was HK\$9m (for the first half of 2013: HK\$8m).

An analysis of the frequency distribution of daily revenue shows that out of 121 trading days for the first half of 2014, losses were recorded on 1 day (for the first half of 2013: 2 days) and maximum daily loss was HK\$3m (for the first half of 2013: HK\$10m). The most frequent result was a daily revenue of between HK\$6m and HK\$24m, with 87 occurrences (for the first half of 2013: 99 occurrences). The highest daily revenue was HK\$46m (for the first half of 2013: HK\$49m).





## **Risk and Capital Management** *(continued)*

### **Risk Management** *(continued)*

#### **(c) Market risk** *(continued)*

##### **Interest rate exposure**

Interest rate risks comprise those originating from Global Markets activities, both trading and non-trading portfolios which include structural interest rate exposures. Global Markets manages interest rate risks within the limits approved by the RMC and under the monitoring of both ALCO and RMC.

##### **Trading**

The Group's control of market risk is based on restricting individual operations to trading within VAR and underlying sensitivity limits including foreign exchange position limits, present value of a basis point limits and option limits, and a list of permissible instruments authorised by the RMC, and enforcing rigorous new product approval procedures. In particular, trading in the derivative products is supported by robust control systems whereas more complicated derivatives are mainly traded on back-to-back basis. Analysis of VAR for trading portfolio is disclosed in "Value at Risk" section.

##### **Non-trading**

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

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

##### **Net interest income**

A principal part of the Group's management of interest rate risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The Group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

## Risk and Capital Management (continued)

### Risk Management (continued)

#### (c) Market risk (continued)

##### Foreign exchange exposure

The Group's foreign exchange exposures mainly comprise foreign exchange dealing by Treasury and currency exposures originated by its banking business. The latter are transferred to Treasury where they are centrally managed within foreign exchange position limits approved by the RMC. The net options position is calculated on the basis of delta-weighted positions of all foreign exchange options contracts.

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

At 30 June 2014, the US dollar ("US\$") was the currency in which the Group had non-structural foreign currency positions that were not less than 10 per cent of the total net position in all foreign currencies. The Group also had a Chinese renminbi ("RMB") structural foreign currency position, which was not less than 10 per cent of the total net structural position in all foreign currencies.

The table below summarises the net structural and non-structural foreign currency positions of the Group.

	US\$	RMB	AUD	EUR	JPY	Other foreign currencies	Total foreign currencies
<b>At 30 June 2014</b>							
<b>Non-structural position</b>							
Spot assets	185,629	152,815	17,195	4,576	31,715	18,360	410,290
Spot liabilities	(162,374)	(146,419)	(23,554)	(8,107)	(6,006)	(29,681)	(376,141)
Forward purchases	310,445	148,522	10,793	9,173	8,943	22,598	510,474
Forward sales	(328,858)	(154,612)	(4,420)	(6,092)	(34,527)	(11,027)	(539,536)
Net options position	60	(225)	54	82	-	13	(16)
Net long/(short)							
non-structural position	4,902	81	68	(368)	125	263	5,071
<b>Structural position</b>	<b>205</b>	<b>36,392</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>601</b>	<b>37,198</b>
<b>At 30 June 2013</b>							
<b>Non-structural position</b>							
Spot assets	173,526	147,750	44,328	12,303	6,417	39,256	423,580
Spot liabilities	(154,308)	(128,555)	(49,486)	(10,226)	(3,194)	(45,435)	(391,204)
Forward purchases	271,887	113,794	10,107	7,496	11,096	13,150	427,530
Forward sales	(292,423)	(129,830)	(5,115)	(9,675)	(13,937)	(6,807)	(457,787)
Net options position	753	(156)	(209)	(76)	(48)	(299)	(35)
Net long/(short)							
non-structural position	(565)	3,003	(375)	(178)	334	(135)	2,084
<b>Structural position</b>	<b>205</b>	<b>34,011</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>478</b>	<b>34,694</b>
<b>At 31 December 2013</b>							
<b>Non-structural position</b>							
Spot assets	176,324	157,293	20,569	4,807	24,445	19,772	403,210
Spot liabilities	(154,695)	(137,449)	(26,347)	(7,621)	(3,046)	(29,731)	(358,889)
Forward purchases	287,769	132,637	13,358	7,320	10,063	18,754	469,901
Forward sales	(310,493)	(150,555)	(7,658)	(4,610)	(31,453)	(8,619)	(513,388)
Net options position	404	(146)	(15)	-	(38)	(177)	28
Net long/(short)							
non-structural position	(691)	1,780	(93)	(104)	(29)	(1)	862
<b>Structural position</b>	<b>205</b>	<b>37,530</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>535</b>	<b>38,270</b>

## **Risk and Capital Management** *(continued)*

### **Risk Management** *(continued)*

#### **(c) Market risk** *(continued)*

##### **Equities exposure**

The Group's equities exposures in 2014 and 2013 are mainly long-term equity investments which are reported as "Financial investments" set out in note 25 to the financial statements. Equities held for trading purpose are included under "Trading assets" set out in note 21 to the financial statements. These are subject to trading limit and risk management control procedures and other market risk regime.

#### **(d) Insurance risk**

##### **Risk management objectives and policies for management of insurance risk**

Through its insurance subsidiaries, the Group offers comprehensive insurance products, including life and non-life insurance, to both personal and commercial customers. These insurance operating subsidiaries are subject to the supervision of the Office of the Commissioner of Insurance and are required to observe the relevant compliance requirements stipulated by the Insurance Commissioner.

The Group is exposed to the uncertainty surrounding the timing and severity of insurance claims under its insurance contracts. The Group also has exposure to market risk through its insurance and investment activities.

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

The Group uses several methods to assess and monitor insurance risk exposures both for individual types of risks insured and overall risks. These methods include internal risk measurement models, sensitivity analyses, scenario analyses and stress testing.

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

##### **Asset/liability management**

The Group actively manages its assets using an approach that considers asset quality, risk profile, diversification, asset/liability matching, liquidity and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Investment Committee and Risk Management Committee of the Group's insurance subsidiaries review and approve the investment policy including asset allocation, investment guidelines and limits on a periodic basis, while the Asset and Liability Management Committee provides oversight of the asset/liability management process.

The Group establishes the investment policy for each major insurance product category according to specific product requirements and local regulatory requirement. The investment policy defines the asset allocations and restrictions with an aim to achieve the target investment return in the long term. The estimates and assumptions used in determining the approximate amounts and timing of payments to or on behalf of policyholders for insurance liabilities are regularly re-evaluated. Actual results may deviate from the estimate and assumption and could impact the Group's ability to achieve its asset/liability management goals and objectives.

## **Risk and Capital Management** *(continued)*

### **Risk Management** *(continued)*

#### **(d) Insurance risk** *(continued)*

##### **Underwriting strategy**

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

##### **Reinsurance strategy**

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

##### **Concentration of insurance risks**

Within the insurance process, concentrations of risk may arise where a particular event or series of events could impact heavily upon the Group's liabilities. Such concentrations may arise from a single insurance contract or through a small number of related contracts, and relate to circumstances where significant liabilities could arise.

The Group is subject to concentration risk arising from accidents relating to common carriers, epidemics, earthquakes and other natural disasters that affect the properties, physical conditions and lives of the policyholders insured by the Group. To mitigate these risks, excess of loss and catastrophe reinsurance arrangements have been made by the Group.

##### **Financial risks**

The Group's insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk.

The Group is also exposed to investment return guarantee risk for certain investment contracts issued to policyholders for its long-term insurance business. The risk is that the yield on the assets held by the Group to meet these guarantees may fall short of the guaranteed return. The framework for the management of this risk is to adopt a matching approach whereby assets held are managed to meet the liability to policyholders. An additional provision is established where analysis indicates that, over the life of the contracts, the returns from the designated assets may not be adequate to cover the related liabilities.

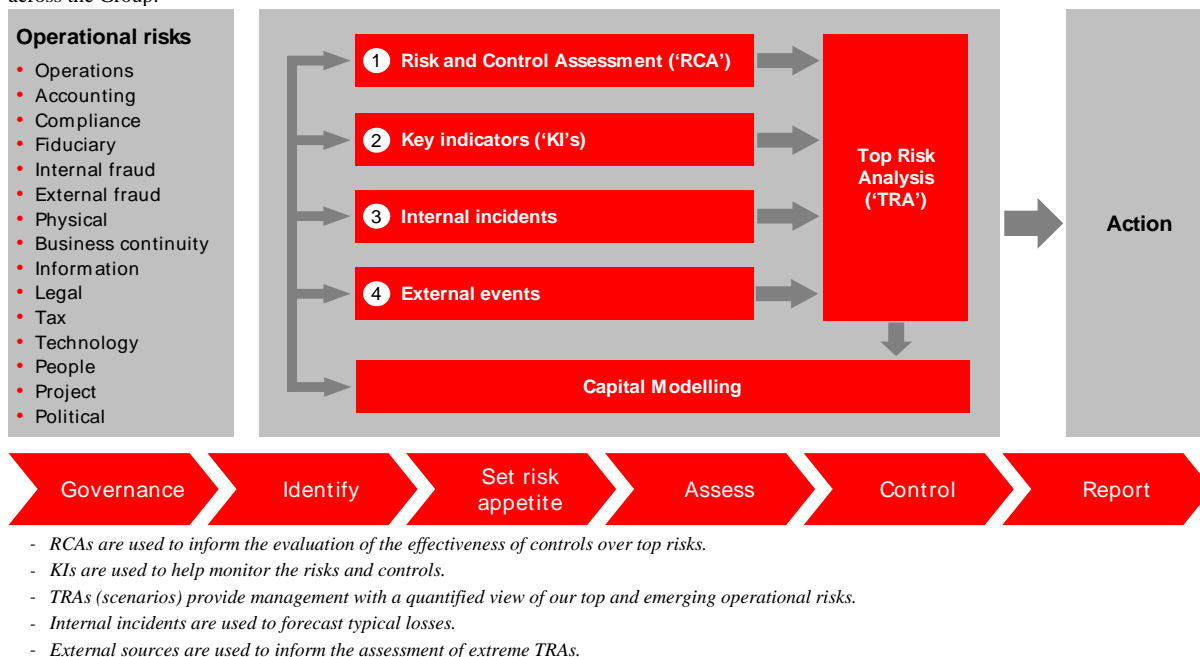
## Risk and Capital Management *(continued)*

### Risk Management *(continued)*

#### (e) Operational risk

##### Operational risk management framework

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



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

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

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

## **Risk and Capital Management** *(continued)*

### **Capital Management**

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

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

The Bank and its subsidiaries maintain a regulatory reserve to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 30 June 2014, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK\$6,063m (31 December 2013: HK\$5,440m).

There are no relevant capital shortfalls in any of the Group's subsidiaries at 30 June 2014 (31 December 2013: nil) which are not included in its consolidation group for regulatory purposes.

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

## Risk and Capital Management (continued)

### Capital Management (continued)

#### Capital Base

The following table sets out the composition of the Group's capital base under Basel III at 30 June 2014, 30 June 2013 and 31 December 2013. These positions benefit from transitional arrangements which will be phased out. A more detailed breakdown of the capital position is available in the Regulatory Disclosures section of our website [www.hangseng.com](http://www.hangseng.com).

	At 30 June 2014	At 30 June 2013	At 31 December 2013
<b>Common Equity Tier 1 ("CET1") Capital</b>			
Shareholders' equity	98,313	93,464	98,068
- Shareholders' equity per balance sheet	109,501	102,081	107,778
- Unconsolidated subsidiaries	(11,188)	(8,617)	(9,710)
Regulatory deductions to CET1 capital	(44,560)	(40,027)	(41,329)
- Cash flow hedging reserve	(1)	(3)	(6)
- Changes in own credit risk on fair valued liabilities	(5)	(109)	(4)
- Property revaluation reserves*	(21,006)	(20,019)	(20,481)
- Regulatory reserve	(6,063)	(5,213)	(5,440)
- Intangible assets	(400)	(565)	(401)
- Defined benefit pension fund assets	(31)	-	(33)
- Deferred tax assets net of deferred tax liabilities	(41)	-	(43)
- Valuation adjustments	(156)	(219)	(180)
- Significant capital investments in unconsolidated financial sector entities	(6,019)	-	(500)
- Excess AT1 deductions	(10,838)	(13,899)	(14,241)
<b>Total CET1 Capital</b>	<b>53,753</b>	<b>53,437</b>	<b>56,739</b>
<b>Additional Tier 1 ("AT1") Capital</b>			
Total AT1 capital before regulatory deductions	-	-	-
Regulatory deductions to AT1 capital	-	-	-
- Significant capital investments in unconsolidated financial sector entities	(10,838)	(13,899)	(14,241)
- Excess AT1 deductions	10,838	13,899	14,241
<b>Total AT1 Capital</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Total Tier 1 ("T1") Capital</b>	<b>53,753</b>	<b>53,437</b>	<b>56,739</b>
<b>Tier 2 ("T2") Capital</b>			
Total T2 capital before regulatory deductions	22,113	22,344	22,518
- Term subordinated debt	9,921	10,880	10,872
- Property revaluation reserves*	9,453	9,009	9,216
- Impairment allowances and regulatory reserve eligible for inclusion in T2 capital	2,739	2,455	2,430
Regulatory deductions to T2 capital	(10,838)	(13,899)	(14,241)
- Significant capital investments in unconsolidated financial sector entities	(10,838)	(13,899)	(14,241)
<b>Total T2 capital</b>	<b>11,275</b>	<b>8,445</b>	<b>8,277</b>
<b>Total Capital</b>	<b>65,028</b>	<b>61,882</b>	<b>65,016</b>

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

## Risk and Capital Management *(continued)*

### Capital Management *(continued)*

#### Capital Base *(continued)*

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 30 June 2014; it is not a projection. On this pro-forma basis, the Group's CET1 capital ratio is 9.4%, which is above the Basel III minimum requirement, including the capital conservation buffer.

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

	At 30 June 2014	At 30 June 2013	At 31 December 2013
<b>CET1 Capital on a transitional basis</b>	<b>53,753</b>	53,437	56,739
Transitional provisions			
- Significant capital investments in unconsolidated financial sector entities	(21,676)	(27,798)	(28,482)
Excess AT1 deductions	10,838	13,899	14,241
<b>CET1 Capital end point basis</b>	<b>42,915</b>	39,538	42,498
<b>AT1 Capital on a transitional basis</b>	<b>-</b>	-	-
Transitional provisions			
- Significant capital investments in unconsolidated financial sector entities	10,838	13,899	14,241
Excess AT1 deductions	(10,838)	(13,899)	(14,241)
<b>AT1 Capital end point basis</b>	<b>-</b>	-	-
<b>T2 Capital on a transitional basis</b>	<b>11,275</b>	8,445	8,277
Grandfathered instruments			
- Term subordinated debt	(7,596)	(8,553)	(8,546)
Transitional provisions			
- Significant capital investments in unconsolidated financial sector entities	10,838	13,899	14,241
<b>T2 Capital end point basis</b>	<b>14,517</b>	13,791	13,972



**Risk and Capital Management** *(continued)***Capital Management** *(continued)***Risk-weighted assets by risk type**

	<b>At 30 June 2014</b>	At 30 June 2013	At 31 December 2013
Credit risk	<b>410,284</b>	350,616	365,077
Market risk	<b>3,918</b>	2,534	4,293
Operational risk	<b>42,628</b>	39,361	41,100
Total	<b>456,830</b>	392,511	410,470

**Market risk-weighted assets**

	<b>At 30 June 2014</b>	At 30 June 2013	At 31 December 2013
Internal models approach			
VAR	<b>930</b>	988	612
Stressed VAR	<b>2,432</b>	1,435	3,470
Standardised approach			
Specific interest rate exposures	<b>556</b>	111	211
Total	<b>3,918</b>	2,534	4,293

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

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

	<b>At 30 June 2014</b>	At 30 June 2013	At 31 December 2013
CET1 capital ratio	<b>11.8%</b>	13.6%	13.8%
Tier 1 capital ratio	<b>11.8%</b>	13.6%	13.8%
Total capital ratio	<b>14.2%</b>	15.8%	15.8%

## Risk and Capital Management (continued)

### Capital Management (continued)

#### Principal subsidiaries and basis of consolidation

The basis of consolidation for financial accounting purposes is in accordance with Hong Kong Financial Reporting Standards ("HKFRS"), as described in note 3 to the financial statements.

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

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

A list of these subsidiaries is shown below:

in HK\$ thousands	Principal activities	At 30 June 2014	
		Total assets*	Total equity*
Hang Seng (Nominee) Ltd	Nominee service	98	87
Hang Seng Bank (Trustee) Ltd	Trustee service	5,081	3,000
Hang Seng Futures Ltd	Futures brokerages	102,654	101,659
Hang Seng Investment Management Ltd	Fund management	774,136	727,038
Hang Seng Investment Services Ltd	Provision of investment commentaries	8,685	8,685
Hang Seng Securities Ltd	Stockbroking	2,804,262	1,535,058
Hang Seng Insurance Co. Ltd	Retirement benefits and life assurance	99,604,859	9,394,665
Hang Seng Bank Trustee International Ltd	Trust business	13,341	8,771

\* Prepared in accordance with HKFRS/ IFRS

As at 30 June 2014, there are no subsidiaries which are included within both the accounting scope of consolidation and the regulatory scope of consolidation but the method of consolidation differs.

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

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

#### Capital instruments

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

	Amount recognised in regulatory capital		
	At 30 June 2014	At 30 June 2013	At 31 December 2013
<b>CET1 capital instruments issued by the Bank</b>			
Ordinary shares:			
1,911,842,736 issued and fully paid ordinary shares	9,658	9,559	9,559
<b>Tier 2 capital instruments</b>			
<u>Issued by the Bank:</u>			
Subordinated loan due 2020 (nominal value: US\$775m)	4,806	5,410	5,407
Subordinated loan due 2021 (nominal value: US\$450m)	2,790	3,143	3,139
Subordinated loan due 2022 (nominal value: US\$300m)	2,325	2,327	2,326

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

#### Additional information

A full reconciliation between the Group's accounting and regulatory balance sheets can be viewed in the Regulatory Disclosures section of our website [www.hangseng.com](http://www.hangseng.com).

# **CONSOLIDATED INCOME STATEMENT**

*unaudited*

*(Expressed in millions of Hong Kong dollars)*

		Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
	note			
Interest income	4	12,774	11,459	12,366
Interest expense	5	(3,103)	(2,490)	(2,731)
<b>Net interest income</b>		<b>9,671</b>	<b>8,969</b>	<b>9,635</b>
Fee income		3,757	3,637	3,692
Fee expense		(695)	(701)	(741)
<b>Net fee income</b>	6	<b>3,062</b>	<b>2,936</b>	<b>2,951</b>
Net trading income	7	1,061	1,204	841
Net income/(loss) from financial instruments designated at fair value	8	428	(111)	456
Dividend income	9	5	4	1,010
Net earned insurance premiums		6,004	5,800	4,205
Other operating income	10	1,131	1,095	841
<b>Total operating income</b>		<b>21,362</b>	<b>19,897</b>	<b>19,939</b>
Net insurance claims incurred and movement in policyholders' liabilities		(6,889)	(6,420)	(5,354)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>		<b>14,473</b>	<b>13,477</b>	<b>14,585</b>
Loan impairment charges and other credit risk provisions	11	(337)	(198)	(338)
<b>Net operating income</b>		<b>14,136</b>	<b>13,279</b>	<b>14,247</b>
Employee compensation and benefits		(2,295)	(2,170)	(2,262)
General and administrative expenses		(1,884)	(1,742)	(2,054)
Depreciation of premises, plant and equipment		(406)	(376)	(386)
Amortisation of intangible assets		(55)	(57)	(56)
<b>Operating expenses</b>	12	<b>(4,640)</b>	<b>(4,345)</b>	<b>(4,758)</b>
Impairment loss on intangible assets		-	-	(13)
<b>Operating profit</b>		<b>9,496</b>	<b>8,934</b>	<b>9,476</b>
Gains less losses from financial investments and fixed assets	13	(5)	173	6
Gain on reclassification of Industrial Bank		-	8,454	-
Loss on reclassification of Yantai Bank		-	-	(297)
Net surplus on property revaluation		230	999	189
Share of profits from associates		156	213	349
<b>Profit before tax</b>		<b>9,877</b>	<b>18,773</b>	<b>9,723</b>
Tax expense	14	(1,409)	(305)	(1,513)
<b>Profit for the period</b>		<b>8,468</b>	<b>18,468</b>	<b>8,210</b>
Profit attributable to shareholders		8,468	18,468	8,210
<i>(Figures in HK\$)</i>				
Earnings per share	15	4.43	9.66	4.29

Details of dividends payable to shareholders of the Bank attributable to the profit for the half year are set out in note 16.

The notes on pages 46 to 93 form part of this interim financial report.

# **CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**

*unaudited*

*(Expressed in millions of Hong Kong dollars)*

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
<b>Profit for the period</b>	<b>8,468</b>	18,468	8,210
<b>Other comprehensive income</b>			
<b>Items that will be reclassified subsequently to the income statement when specific conditions are met:</b>			
Available-for-sale investment reserve:			
- fair value changes taken to equity:			
-- on debt securities	350	(685)	(228)
-- on equity shares	(417)	(3,458)	820
- fair value changes transferred to income statement:			
-- on hedged items	29	461	228
-- on disposal	2	-	(1)
- share of changes in equity of associates:			
-- fair value changes	-	4	(5)
-- fair value changes transferred to income statement on reclassification of Industrial Bank and Yantai Bank	-	94	17
- deferred taxes	(76)	42	15
- exchange difference and others	(730)	431	420
Cash flow hedging reserve:			
- fair value changes taken to equity	(74)	498	(66)
- fair value changes transferred to income statement	70	(516)	71
- deferred taxes	1	3	(1)
Exchange differences on translation of:			
- financial statements of overseas branches, subsidiaries and associates	(170)	338	100
- cumulative foreign exchange reserve transferred to income statement on reclassification of Industrial Bank and Yantai Bank	-	(2,039)	(111)
- other	-	(3)	5
Others	-	30	-
<b>Items that will not be reclassified subsequently to the income statement:</b>			
Premises:			
- unrealised surplus on revaluation of premises	612	1,526	577
- deferred taxes	(103)	(241)	(96)
- exchange difference	(1)	2	1
Defined benefit plans:			
- actuarial gains/(losses) on defined benefit plans	75	855	(77)
- deferred taxes	(12)	(141)	13
Share-based payments	(1)	(1)	(2)
<b>Other comprehensive income for the period, net of tax</b>	<b>(445)</b>	(2,800)	1,680
<b>Total comprehensive income for the period</b>	<b>8,023</b>	15,668	9,890
Total comprehensive income for the period attributable to shareholders	8,023	15,668	9,890

# **CONSOLIDATED BALANCE SHEET**

*unaudited*

*(Expressed in millions of Hong Kong dollars)*

		<b>At 30 June 2014</b>	At 30 June 2013	At 31 December 2013
	note		(restated)	
<b>ASSETS</b>				
Cash and balances at central banks	19	<b>7,721</b>	9,798	22,717
Placings with and advances to banks	20	<b>142,975</b>	141,012	141,940
Trading assets	21	<b>26,213</b>	34,509	31,996
Financial assets designated at fair value	22	<b>10,331</b>	10,150	6,987
Derivative financial instruments	23	<b>6,296</b>	4,752	6,646
Reverse repurchase agreements – non trading		<b>2,309</b>	-	-
Loans and advances to customers	24	<b>632,947</b>	579,705	586,240
Financial investments	25	<b>297,303</b>	263,369	282,845
Interest in associates	26	<b>2,178</b>	2,753	2,062
Investment properties	27	<b>11,108</b>	10,547	10,918
Premises, plant and equipment	28	<b>21,594</b>	20,690	21,000
Intangible assets	29	<b>8,779</b>	7,403	7,974
Other assets	30	<b>26,210</b>	21,969	22,405
<b>Total assets</b>		<b>1,195,964</b>	1,106,657	1,143,730
<b>LIABILITIES AND EQUITY</b>				
<b>Liabilities</b>				
Current, savings and other deposit accounts	31	<b>860,092</b>	779,884	824,996
Repurchase agreements – non trading		<b>1,837</b>	1,625	-
Deposits from banks		<b>11,335</b>	14,165	11,826
Trading liabilities	32	<b>65,713</b>	67,749	62,117
Financial liabilities designated at fair value		<b>493</b>	466	489
Derivative financial instruments	23	<b>5,825</b>	4,817	5,246
Certificates of deposit and other debt securities in issue	33	<b>9,904</b>	11,022	8,601
Other liabilities	34	<b>24,451</b>	20,874	20,467
Liabilities to customers under insurance contracts		<b>89,049</b>	86,584	85,844
Current tax liabilities		<b>1,830</b>	1,928	692
Deferred tax liabilities		<b>4,114</b>	3,633	3,850
Subordinated liabilities	35	<b>11,820</b>	11,829	11,824
<b>Total liabilities</b>		<b>1,086,463</b>	1,004,576	1,035,952
<b>Equity</b>				
Share capital		<b>9,658</b>	9,559	9,559
Retained profits		<b>83,215</b>	76,633	78,679
Other reserves		<b>14,525</b>	13,786	15,334
Proposed dividends		<b>2,103</b>	2,103	4,206
Shareholders' funds	36	<b>109,501</b>	102,081	107,778
<b>Total equity and liabilities</b>		<b>1,195,964</b>	1,106,657	1,143,730

The notes on pages 46 to 93 form part of this interim financial report.

# **CONSOLIDATED STATEMENT OF CHANGES IN EQUITY**

*unaudited*

*(Expressed in millions of Hong Kong dollars)*

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
<b>Share capital</b>			
At beginning and end of period	9,559	9,559	9,559
Transfer from capital redemption reserve	99	-	-
	<u>9,658</u>	<u>9,559</u>	<u>9,559</u>
<b>Retained profits (including proposed dividends)</b>			
At beginning of period	82,885	63,507	78,736
Dividends to shareholders			
- dividends approved in respect of the previous year	(4,206)	(3,824)	-
- dividends declared in respect of the current period	(2,103)	(2,103)	(4,206)
Transfer	212	1,978	206
Total comprehensive income for the period	8,530	19,178	8,149
	<u>85,318</u>	<u>78,736</u>	<u>82,885</u>
<b>Other reserves</b>			
Premises revaluation reserve			
At beginning of period	14,904	13,790	14,628
Transfer	(212)	(449)	(206)
Total comprehensive income for the period	508	1,287	482
	<u>15,200</u>	<u>14,628</u>	<u>14,904</u>
Available-for-sale investment reserve			
At beginning of period	(1,618)	227	(2,884)
Total comprehensive income for the period	(842)	(3,111)	1,266
	<u>(2,460)</u>	<u>(2,884)</u>	<u>(1,618)</u>
Cash flow hedging reserve			
At beginning of period	6	17	2
Total comprehensive income for the period	(3)	(15)	4
	<u>3</u>	<u>2</u>	<u>6</u>
Foreign exchange reserve			
At beginning of period	1,295	3,071	1,306
Transfer	-	(64)	-
Total comprehensive income for the period	(170)	(1,701)	(11)
	<u>1,125</u>	<u>1,306</u>	<u>1,295</u>
<b>Other reserves</b>			
At beginning of period	747	2,152	734
Cost of share-based payment arrangements	9	17	13
Transfer	-	(1,465)	-
Transfer of capital redemption reserve	(99)	-	-
Total comprehensive income for the period	-	30	-
	<u>657</u>	<u>734</u>	<u>747</u>
<b>Total equity</b>			
At beginning of period	107,778	92,323	102,081
Dividends to shareholders	(6,309)	(5,927)	(4,206)
Cost of share-based payment arrangements	9	17	13
Total comprehensive income for the period	8,023	15,668	9,890
	<u>109,501</u>	<u>102,081</u>	<u>107,778</u>

## CONSOLIDATED CASH FLOW STATEMENT

unaudited

(Expressed in millions of Hong Kong dollars)

		Half-year ended 30 June 2014	Half-year ended 30 June 2013 (restated)
	note		
<b>Net cash (outflow)/inflow from operating activities</b>	37(a)	<b>(6,833)</b>	<b>3,607</b>
<b>Cash flows from investing activities</b>			
Dividends received from associates		-	-
Purchase of available-for-sale investments		(27,896)	(23,729)
Purchase of held-to-maturity debt securities		(430)	(953)
Proceeds from sale or redemption of available-for-sale investments		27,001	16,177
Proceeds from redemption of held-to-maturity debt securities		315	55
Net cash inflow from sale of loan portfolio		368	-
Purchase of premises, plant and equipment and intangible assets		(397)	(3,229)
Proceeds from sale of premises, plant and equipment and assets held for sale		2	910
Interest received from available-for-sale investments		731	826
Dividends received from available-for-sale investments		6	5
Net cash outflow from investing activities		(300)	(9,938)
<b>Cash flows from financing activities</b>			
Dividends paid		(6,309)	(5,927)
Interest paid for subordinated liabilities		(152)	(155)
Net cash outflow from financing activities		(6,461)	(6,082)
<b>Decrease in cash and cash equivalents</b>		<b>(13,594)</b>	<b>(12,413)</b>
<b>Cash and cash equivalents at 1 January</b>		<b>115,779</b>	<b>115,947</b>
Effect of foreign exchange rate changes		42	(2,557)
<b>Cash and cash equivalents at 30 June</b>	37(b)	<b>102,227</b>	<b>100,977</b>

The notes on pages 46 to 93 form part of this interim financial report.

## NOTES TO THE FINANCIAL STATEMENTS (unaudited)

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

### 1 Basis of preparation

This interim financial report has been prepared in accordance with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited and in compliance with Hong Kong Accounting Standard ("HKAS") 34, Interim Financial Reporting, issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). It also contains the disclosure information required under the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance. The interim financial report was authorised for issue on 4 August 2014.

The preparation of an interim financial report in conformity with HKAS 34 requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses on a year to date basis. Actual results may differ from these estimates.

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 to the Financial Statements" and "Risk and Capital Management" section goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements.

The interim financial report is unaudited, but has been reviewed by KPMG in accordance with Hong Kong Standards on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, issued by HKICPA. KPMG's independent review report to the Board of Directors is included on page 94.

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### 2 Accounting policies

Except as described below, the accounting policies applied in preparing this interim financial report are the same as those applied in preparing the financial statements for the year ended 31 December 2013, as disclosed in the Annual Report and Financial Statements for 2013.

The Group has adopted the following new standards and amendments to standards which had insignificant or no effect on the consolidated financial statements:

- Amendments to Hong Kong Accounting Standard ("HKAS") 32 "Offsetting Financial Assets and Financial Liabilities"
- Amendments to HKAS 39 "Financial Instruments: Recognition and Measurement – Novation of Derivatives and Continuation of Hedge Accounting"
- Amendments to Hong Kong Financial Reporting Standard ("HKFRS") 10, HKFRS 12 and HKAS 27 "Investment Entities"
- Amendments to HKAS 36 "Impairment of Assets: Recoverable Amounts Disclosures for Non-Financial Assets"
- Hong Kong (International Financial Reporting Standards Interpretations Committee) "HK(IFRIC)" Interpretation 21 "Leases"

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### 3 Basis of consolidation

This interim financial report covers the consolidated positions of Hang Seng Bank Limited ("the Bank") and all its subsidiaries ("the Group"), unless otherwise stated, and includes the attributable share of the results and reserves of its associates. For regulatory reporting, the basis of consolidation is different from the basis of consolidation for accounting purposes. They are disclosed under the "Risk and Capital Management" section.



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

### 4 Interest income

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Interest income arising from:			
- financial assets that are not at fair value through profit and loss	12,687	11,334	12,279
- trading assets	85	91	62
- financial assets designated at fair value	2	34	25
	<u>12,774</u>	<u>11,459</u>	<u>12,366</u>
of which:			
- interest income from listed investments	1,079	875	949
- interest income from unlisted investments	1,490	1,520	1,527
- interest income from impaired financial assets	9	8	5

### 5 Interest expense

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Interest expense arising from:			
- financial liabilities that are not at fair value through profit and loss	1,933	1,629	1,742
- trading liabilities	1,170	861	989
- financial liabilities designated at fair value	-	-	-
	<u>3,103</u>	<u>2,490</u>	<u>2,731</u>
of which:			
- interest expense from debt securities in issue maturing after five years	-	-	-
- interest expense from customer accounts maturing after five years	-	-	-
- interest expense from subordinated liabilities	152	155	156

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

## 6 Net fee income

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
- stockbroking and related services	511	535	538
- retail investment funds	891	845	703
- insurance	249	223	218
- account services	184	179	175
- private banking service fee	54	53	51
- remittances	193	158	190
- cards	1,051	1,016	1,126
- credit facilities	185	163	207
- trade services	260	284	301
- other	179	181	183
Fee income	3,757	3,637	3,692
Fee expense	(695)	(701)	(741)
	<u>3,062</u>	<u>2,936</u>	<u>2,951</u>
of which:			
Net fee income, other than amounts included in determining the effective interest rate, arising from financial assets or financial liabilities that are not held for trading nor designated at fair value	1,134	1,083	1,221
- fee income	1,697	1,640	1,808
- fee expense	(563)	(557)	(587)
Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers	326	335	339
- fee income	396	416	428
- fee expense	(70)	(81)	(89)

## 7 Net trading income

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Dealing profits	1,067	1,215	837
- foreign exchange	995	1,190	774
- interest rate derivatives	(1)	35	29
- debt securities	43	(6)	(29)
- equities and other trading	30	(4)	63
Net income/(loss) from hedging activities	(6)	(11)	4
- fair value hedges			
-- net income/(loss) on hedged items attributable to the hedged risk	(29)	(461)	(228)
-- net income/(loss) on hedging instruments	23	453	227
- cash flow hedges			
-- net hedging income/(loss)	-	(3)	5
	<u>1,061</u>	<u>1,204</u>	<u>841</u>

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

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

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Net income/(loss) on assets designated at fair value which back insurance and investment contracts	<u>428</u>	<u>(111)</u>	<u>456</u>
of which dividend income from:			
- listed investments	116	47	34
- unlisted investments	<u>-</u>	<u>-</u>	<u>1</u>
	<u>116</u>	<u>47</u>	<u>35</u>

## 9 Dividend income

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Dividend income:			
- listed investments	-	-	999
- unlisted investments	<u>5</u>	<u>4</u>	<u>11</u>
	<u>5</u>	<u>4</u>	<u>1,010</u>

## 10 Other operating income

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Rental income from investment properties	195	106	187
Movement in present value of in-force long-term insurance business	807	622	573
Others	<u>129</u>	<u>367</u>	<u>81</u>
	<u>1,131</u>	<u>1,095</u>	<u>841</u>

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

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

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Net charge for impairment of loans and advances to customers (note 24(b)):			
Individually assessed impairment allowances:			
- new allowances	(179)	(61)	(130)
- releases	91	57	34
- recoveries	31	7	9
	<u>(57)</u>	<u>3</u>	<u>(87)</u>
Net charge for collectively assessed impairment allowances	(252)	(201)	(251)
Other credit risk provisions	<u>(28)</u>	<u>-</u>	<u>-</u>
Loan impairment charges and other credit risk provisions	<u><u>(337)</u></u>	<u><u>(198)</u></u>	<u><u>(338)</u></u>

There were no impairment charges (nil for the first and second halves of 2013) provided for available-for-sale debt securities, held-to-maturity debt securities and placings with and advances to banks by the Group.

### 12 Operating expenses

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Employee compensation and benefits:			
- salaries and other costs	2,071	1,953	2,038
- retirement benefit costs			
- defined benefit scheme	149	154	156
- defined contribution scheme	75	63	68
	<u>2,295</u>	<u>2,170</u>	<u>2,262</u>
General and administrative expenses:			
- rental expenses	336	315	330
- other premises and equipment	507	519	579
- marketing and advertising expenses	381	322	391
- other operating expenses	660	586	754
	<u>1,884</u>	<u>1,742</u>	<u>2,054</u>
Depreciation of premises, plant and equipment (note 28)	406	376	386
Amortisation of intangible assets	55	57	56
	<u><u>4,640</u></u>	<u><u>4,345</u></u>	<u><u>4,758</u></u>

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

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

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Net gains from disposal of available-for-sale equity securities	(3)	-	-
Net gains from disposal of available-for-sale debt securities	1	-	1
Gains less losses on disposal of assets held for sale	-	175	2
Gains less losses on disposal of loans and advances	2	1	4
Gains less losses on disposal of fixed assets	(5)	(3)	(1)
	<u>(5)</u>	<u>173</u>	<u>6</u>

There were no impairment losses or gains less losses on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost for the periods indicated.

### 14 Tax expense

Taxation in the consolidated income statement represents:

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
<b>Current tax - provision for Hong Kong profits tax</b>			
Tax for the period	1,396	1,298	1,236
Adjustment in respect of prior periods	(96)	-	(14)
	<u>1,300</u>	<u>1,298</u>	<u>1,222</u>
<b>Current tax - taxation outside Hong Kong</b>			
Tax for the period	13	52	161
Adjustment in respect of prior periods	12	7	-
	<u>25</u>	<u>59</u>	<u>161</u>
<b>Deferred tax</b>			
Origination and reversal of temporary differences	84	(1,052)	130
<b>Total tax expense</b>	<u>1,409</u>	<u>305</u>	<u>1,513</u>

The current tax provision is based on the estimated assessable profit for the first half of 2014, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 16.5 per cent (2013: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised.

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

### 15 Earnings per share

The calculation of earnings per share for the first half of 2014 is based on earnings of HK\$8,468m (HK\$18,468m and HK\$8,210m for the first and second halves of 2013 respectively) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from the first and second halves of 2013).

### 16 Dividends per share

	Half-year ended 30 June 2014		Half-year ended 30 June 2013		Half-year ended 31 December 2013	
	HK\$ per share	HK\$m	HK\$ per share	HK\$m	HK\$ per share	HK\$m
First interim	1.10	2,103	1.10	2,103	-	-
Second interim	1.10	2,103	1.10	2,103	-	-
Third interim	-	-	-	-	1.10	2,103
Fourth interim	-	-	-	-	2.20	4,206
	<b>2.20</b>	<b>4,206</b>	<b>2.20</b>	<b>4,206</b>	<b>3.30</b>	<b>6,309</b>

### 17 Segmental analysis

HKFRS 8 requires segmental disclosure to be based on the way that the Group's chief operating decision maker regards and manages the Group, with the amounts reported for each reportable segment being the measures reported to the Group's chief operating decision maker for the purpose of assessing segmental performance and making decisions about operating matters. In 2014, there was a change in the reportable segments information reported internally to the Group's most senior executive management for the purposes of resources allocation and performance assessment. To align with the internal reporting information, the Group has presented the following five reportable segments. Corresponding amounts have been restated to ensure information is provided on a basis consistent with the revised segment information. Consolidation adjustments made in preparing the Group's financial statements and inter-segment elimination of income or expenses upon consolidation are included in the "Inter-segment elimination".

#### *Hong Kong and other businesses segment*

- **Retail Banking and Wealth Management** activities offer a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance and wealth management;
- **Commercial Banking** activities offer a comprehensive suite of products and services to corporate, commercial and SME customers – including corporate lending, trade and receivable finance, payments and cash management, treasury and foreign exchange, general insurance, key-person insurance, investment services and corporate wealth management;
- **Global Banking and Markets** provides tailored financial solutions to major corporate and institutional clients. Undertaking a long-term relationships management approach, its services include general banking, corporate lending, interest rates, foreign exchange, money markets, structural products and derivatives, etc. Global Banking and Markets also manages the funding and liquidity positions of the Bank and other market risk positions arising from banking activities;
- **Other** mainly represents management of shareholders' funds and investments in premises, investment properties, equity shares and subordinated debt funding;

#### *Mainland China business segment*

- **Mainland China** business segment comprises the business of Hang Seng Bank (China) Limited and our share of profits from Mainland associates.

#### **(a) Segmental result**

For the purpose of segmental analysis, the allocation of revenue reflects the benefits of capital and other funding resources allocated to the business segments by way of internal capital allocation and fund transfer-pricing mechanisms. Cost allocation is based on the direct costs incurred by the respective business segments and apportionment of management overheads. Bank-owned premises are reported under "Other" segment. When these premises are utilised by Global Businesses, notional rent will be charged to the relevant business segments based on market rates.

NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

17 Segmental analysis (continued)

(a) Segmental result (continued)

	Hong Kong and other businesses							
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Market	Other	Total	Mainland China business	Inter- segment elimination	Total
<b>Half-year ended 30 June 2014</b>								
Net interest income/(expense)	4,888	2,228	1,764	(75)	8,805	866	-	9,671
Net fee income/(expense)	2,030	787	120	72	3,009	53	-	3,062
Net trading income/(loss)	140	266	579	-	985	76	-	1,061
Net income/(loss) from financial instruments designated at fair value	429	(1)	-	-	428	-	-	428
Dividend income	1	-	-	4	5	-	-	5
Net earned insurance premiums	5,950	54	-	-	6,004	-	-	6,004
Other operating income	903	45	-	223	1,171	1	(41)	1,131
<b>Total operating income</b>	<b>14,341</b>	<b>3,379</b>	<b>2,463</b>	<b>224</b>	<b>20,407</b>	<b>996</b>	<b>(41)</b>	<b>21,362</b>
Net insurance claims incurred and movement in policyholders' liabilities	(6,847)	(42)	-	-	(6,889)	-	-	(6,889)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>7,494</b>	<b>3,337</b>	<b>2,463</b>	<b>224</b>	<b>13,518</b>	<b>996</b>	<b>(41)</b>	<b>14,473</b>
Loan impairment (charges)/releases and other credit risk provisions	(247)	12	-	-	(235)	(102)	-	(337)
<b>Net operating income</b>	<b>7,247</b>	<b>3,349</b>	<b>2,463</b>	<b>224</b>	<b>13,283</b>	<b>894</b>	<b>(41)</b>	<b>14,136</b>
Operating expenses *	(2,750)	(861)	(287)	(52)	(3,950)	(731)	41	(4,640)
<b>Operating profit</b>	<b>4,497</b>	<b>2,488</b>	<b>2,176</b>	<b>172</b>	<b>9,333</b>	<b>163</b>	<b>-</b>	<b>9,496</b>
Gains less losses from financial investments and fixed assets	-	-	3	(7)	(4)	(1)	-	(5)
Net surplus on property revaluation	-	-	-	230	230	-	-	230
Share of profits from associates	155	1	-	-	156	-	-	156
<b>Profit before tax</b>	<b>4,652</b>	<b>2,489</b>	<b>2,179</b>	<b>395</b>	<b>9,715</b>	<b>162</b>	<b>-</b>	<b>9,877</b>
Share of profit before tax	47.1%	25.2%	22.1%	4.0%	98.4%	1.6%	-	100.0%
Share of profit before tax as a percentage of Hong Kong and other businesses	47.9%	25.6%	22.4%	4.1%	100.0%			
Operating profit excluding loan impairment charges and other credit risk provisions	4,744	2,476	2,176	172	9,568	265	-	9,833
* Depreciation/amortisation included in operating expenses	(23)	(14)	(2)	(373)	(412)	(49)	-	(461)

At 30 June 2014

Total assets	324,699	239,280	443,493	87,449	1,094,921	125,434	(24,391)	1,195,964
Total liabilities	663,013	189,121	115,121	20,563	987,818	115,308	(16,663)	1,086,463
Interest in associates	2,137	12	-	-	2,149	29	-	2,178

NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

17 Segmental analysis (continued)

(a) Segmental result (continued)

	Hong Kong and other businesses					Mainland China business	Inter-segment elimination	Total
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Market	Other	Total			
Half-year ended 30 June 2013 (restated)								
Net interest income/(expense)	4,917	2,008	1,508	(113)	8,320	649	-	8,969
Net fee income/(expense)	1,955	793	83	66	2,897	39	-	2,936
Net trading income/(loss)	89	327	689	(9)	1,096	108	-	1,204
Net income/(loss) from financial instruments designated at fair value	(108)	(3)	-	-	(111)	-	-	(111)
Dividend income	-	-	-	4	4	-	-	4
Net earned insurance premiums	5,761	39	-	-	5,800	-	-	5,800
Other operating income	956	25	-	140	1,121	-	(26)	1,095
<b>Total operating income</b>	<b>13,570</b>	<b>3,189</b>	<b>2,280</b>	<b>88</b>	<b>19,127</b>	<b>796</b>	<b>(26)</b>	<b>19,897</b>
Net insurance claims incurred and movement in policyholders' liabilities	(6,381)	(39)	-	-	(6,420)	-	-	(6,420)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>7,189</b>	<b>3,150</b>	<b>2,280</b>	<b>88</b>	<b>12,707</b>	<b>796</b>	<b>(26)</b>	<b>13,477</b>
Loan impairment (charges)/releases and other credit risk provisions	(280)	59	6	-	(215)	17	-	(198)
<b>Net operating income</b>	<b>6,909</b>	<b>3,209</b>	<b>2,286</b>	<b>88</b>	<b>12,492</b>	<b>813</b>	<b>(26)</b>	<b>13,279</b>
Operating expenses *	(2,615)	(787)	(250)	(35)	(3,687)	(684)	26	(4,345)
<b>Operating profit</b>	<b>4,294</b>	<b>2,422</b>	<b>2,036</b>	<b>53</b>	<b>8,805</b>	<b>129</b>	<b>-</b>	<b>8,934</b>
Gains less losses from financial investments and fixed assets	(1)	-	1	173	173	-	-	173
Gain on reclassification of Industrial Bank	-	-	-	-	-	8,454	-	8,454
Net surplus on property revaluation	-	-	-	999	999	-	-	999
Share of profits from associates	162	1	-	-	163	50	-	213
<b>Profit before tax</b>	<b>4,455</b>	<b>2,423</b>	<b>2,037</b>	<b>1,225</b>	<b>10,140</b>	<b>8,633</b>	<b>-</b>	<b>18,773</b>
Share of profit before tax	23.8%	12.9%	10.8%	6.5%	54.0%	46.0%	-	100.0%
Share of profit before tax as a percentage of Hong Kong and other businesses	43.9%	23.9%	20.1%	12.1%	100.0%			
Operating profit excluding loan impairment charges and other credit risk provisions	4,574	2,363	2,030	53	9,020	112	-	9,132
* Depreciation/amortisation included in operating expenses	(24)	(12)	(2)	(345)	(383)	(50)	-	(433)

At 30 June 2013

Total assets	307,081	215,914	392,251	98,429	1,013,675	118,176	(25,194)	1,106,657
Total liabilities	621,704	162,820	83,686	46,569	914,779	109,913	(20,116)	1,004,576
Interest in associates	1,769	9	-	-	1,778	975	-	2,753



NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

17 Segmental analysis (continued)

(a) Segmental result (continued)

	Hong Kong and other businesses							
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Market	Other	Total	Mainland China business	Inter- segment elimination	Total
Half-year ended 31 December 2013 <i>(restated)</i>								
Net interest income/(expense)	5,042	2,163	1,728	(108)	8,825	810	-	9,635
Net fee income/(expense)	1,894	772	148	78	2,892	59	-	2,951
Net trading income/(loss)	211	179	433	(5)	818	23	-	841
Net income/(loss) from financial instruments designated at fair value	458	(1)	(1)	-	456	-	-	456
Dividend income	-	7	-	1,003	1,010	-	-	1,010
Net earned insurance premiums	4,164	41	-	-	4,205	-	-	4,205
Other operating income	656	14	1	194	865	7	(31)	841
<b>Total operating income</b>	<b>12,425</b>	<b>3,175</b>	<b>2,309</b>	<b>1,162</b>	<b>19,071</b>	<b>899</b>	<b>(31)</b>	<b>19,939</b>
Net insurance claims incurred and movement in policyholders' liabilities	(5,321)	(33)	-	-	(5,354)	-	-	(5,354)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>7,104</b>	<b>3,142</b>	<b>2,309</b>	<b>1,162</b>	<b>13,717</b>	<b>899</b>	<b>(31)</b>	<b>14,585</b>
Loan impairment (charges)/releases and other credit risk provisions	(202)	(97)	(14)	-	(313)	(25)	-	(338)
<b>Net operating income</b>	<b>6,902</b>	<b>3,045</b>	<b>2,295</b>	<b>1,162</b>	<b>13,404</b>	<b>874</b>	<b>(31)</b>	<b>14,247</b>
Operating expenses *	(2,700)	(834)	(265)	(195)	(3,994)	(795)	31	(4,758)
Impairment loss on intangible assets	(11)	(2)	-	-	(13)	-	-	(13)
<b>Operating profit</b>	<b>4,191</b>	<b>2,209</b>	<b>2,030</b>	<b>967</b>	<b>9,397</b>	<b>79</b>	<b>-</b>	<b>9,476</b>
Gains less losses from financial investments and fixed assets	-	1	3	3	7	(1)	-	6
Loss on reclassification of Yantai Bank	-	-	-	-	-	(297)	-	(297)
Net surplus on property revaluation	-	-	-	189	189	-	-	189
Share of profits from associates	293	1	-	-	294	55	-	349
<b>Profit before tax</b>	<b>4,484</b>	<b>2,211</b>	<b>2,033</b>	<b>1,159</b>	<b>9,887</b>	<b>(164)</b>	<b>-</b>	<b>9,723</b>
Share of profit before tax	46.1%	22.7%	20.9%	12.0%	101.7%	(1.7%)	-	100.0%
Share of profit before tax as a percentage of Hong Kong and other businesses	45.4%	22.4%	20.6%	11.6%	100.0%			
Operating profit excluding loan impairment charges and other credit risk provisions	4,393	2,306	2,044	967	9,710	104	-	9,814
<i>* Depreciation/amortisation included in operating expenses</i>								
	(25)	(16)	(3)	(350)	(394)	(48)	-	(442)

At 31 December 2013

Total assets	309,758	211,747	426,288	104,027	1,051,820	118,476	(26,566)	1,143,730
Total liabilities	650,309	173,675	105,484	16,924	946,392	108,495	(18,935)	1,035,952
Interest in associates	2,022	10	-	-	2,032	30	-	2,062

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

## 17 Segmental analysis (continued)

### (b) Geographic information

The geographical regions in this analysis are classified by the location of the principal operations of the subsidiary companies or, in the case of the Bank itself, by the location of the branches responsible for reporting the results or advancing the funds.

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
<b>Total operating income</b>			
Hong Kong	20,307	18,640	18,818
Mainland	996	796	899
Americas	-	421	179
Others	100	81	90
Inter-segment elimination	(41)	(41)	(47)
	<u>21,362</u>	<u>19,897</u>	<u>19,939</u>
<b>Profit before tax</b>			
Hong Kong	9,654	9,683	9,660
Mainland	162	8,633	(164)
Americas	(8)	404	169
Others	69	53	58
	<u>9,877</u>	<u>18,773</u>	<u>9,723</u>
	At 30 June 2014	At 30 June 2013	At 31 December 2013
<b>Total assets</b>			
Hong Kong	1,090,718	1,008,809	1,048,106
Mainland	125,434	118,176	118,476
Americas	34	57,583	185
Others	14,879	10,996	12,702
Inter-segment elimination	(35,101)	(88,907)	(35,739)
	<u>1,195,964</u>	<u>1,106,657</u>	<u>1,143,730</u>
<b>Total liabilities</b>			
Hong Kong	984,146	911,782	943,141
Mainland	115,308	109,913	108,495
Americas	5	56,008	48
Others	14,482	10,703	12,356
Inter-segment elimination	(27,478)	(83,830)	(28,088)
	<u>1,086,463</u>	<u>1,004,576</u>	<u>1,035,952</u>
<b>Equity</b>			
Hong Kong	106,572	97,027	104,965
Mainland	10,126	8,263	9,981
Americas	29	1,575	137
Others	397	293	346
Inter-segment elimination	(7,623)	(5,077)	(7,651)
	<u>109,501</u>	<u>102,081</u>	<u>107,778</u>
<i>of which:</i>			
<b>Share capital</b>			
Hong Kong	9,658	9,559	9,559
Mainland	8,691	6,224	8,847
Americas	18	18	18
Others	12	12	12
Inter-segment elimination	(8,721)	(6,254)	(8,877)
	<u>9,658</u>	<u>9,559</u>	<u>9,559</u>
<b>Interest in associates</b>			
Hong Kong	2,149	1,778	2,032
Mainland	29	975	30
Americas	-	-	-
Others	-	-	-
	<u>2,178</u>	<u>2,753</u>	<u>2,062</u>
<b>Non-current assets*</b>			
Hong Kong	40,384	37,556	38,786
Mainland	1,096	1,083	1,105
Americas	-	-	-
Others	1	1	1
	<u>41,481</u>	<u>38,640</u>	<u>39,892</u>
<b>Contingent liabilities and commitments</b>			
Hong Kong	282,054	272,675	269,197
Mainland	36,271	37,389	34,129
Americas	-	-	-
Others	3,229	4,112	3,152
	<u>321,554</u>	<u>314,176</u>	<u>306,478</u>

\* Non-current assets consist of properties, plant and equipment, goodwill and other intangible assets.

NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

18 Analysis of assets and liabilities by remaining maturity

The maturity analysis is based on the remaining contractual maturity at the balance sheet date, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
<b>Assets</b>									
Cash and balances at central banks	7,721	-	-	-	-	-	-	-	7,721
Placings with and advances to banks	12,710	68,633	55,493	4,070	-	2,069	-	-	142,975
Trading assets	-	-	-	-	-	-	26,213	-	26,213
Financial assets designated at fair value	-	-	-	-	9	51	-	10,271	10,331
Derivative financial instruments	-	-	-	422	61	6	5,807	-	6,296
Reverse repurchase agreements - non trading	-	2,309	-	-	-	-	-	-	2,309
Loans and advances to customers	12,020	56,642	59,018	119,318	211,595	174,354	-	-	632,947
Financial investments:									
- available-for-sale investments	-	32,443	60,049	61,129	43,444	2,819	-	27,191	227,075
- held-to-maturity debt securities	-	104	1,096	4,506	26,290	38,232	-	-	70,228
Interest in associates	-	-	-	-	-	-	-	2,178	2,178
Investment properties	-	-	-	-	-	-	-	11,108	11,108
Premises, plant and equipment	-	-	-	-	-	-	-	21,594	21,594
Intangible assets	-	-	-	-	-	-	-	8,779	8,779
Other assets	10,095	6,246	3,571	3,551	2,162	136	-	449	26,210
<b>At 30 June 2014</b>	<b>42,546</b>	<b>166,377</b>	<b>179,227</b>	<b>192,996</b>	<b>283,561</b>	<b>217,667</b>	<b>32,020</b>	<b>81,570</b>	<b>1,195,964</b>
At 30 June 2013	39,409	156,266	157,063	173,344	259,319	208,438	38,374	74,444	1,106,657
At 31 December 2013	55,158	149,115	165,051	186,058	263,094	210,512	37,866	76,876	1,143,730
<b>Liabilities</b>									
Current, savings and other deposit accounts	590,182	123,297	92,093	52,004	2,516	-	-	-	860,092
Repurchase agreements - non trading	-	1,837	-	-	-	-	-	-	1,837
Deposits from banks	4,905	6,430	-	-	-	-	-	-	11,335
Trading liabilities	-	-	-	-	-	-	65,713	-	65,713
Financial liabilities designated at fair value	2	-	-	-	-	491	-	-	493
Derivative financial instruments	-	13	55	141	387	105	5,124	-	5,825
Certificates of deposit and other debt securities in issue:									
- certificates of deposit in issue	-	-	-	4,660	4,000	-	-	-	8,660
- other debt securities in issue	-	-	-	-	1,244	-	-	-	1,244
Other liabilities	8,261	6,255	3,549	3,572	86	67	-	2,661	24,451
Liabilities to customers under insurance contracts	-	-	-	-	-	-	-	89,049	89,049
Current tax liabilities	-	-	6	1,818	6	-	-	-	1,830
Deferred tax liabilities	-	-	-	-	-	-	-	4,114	4,114
Subordinated liabilities	-	-	-	-	-	11,820	-	-	11,820
<b>At 30 June 2014</b>	<b>603,350</b>	<b>137,832</b>	<b>95,703</b>	<b>62,195</b>	<b>8,239</b>	<b>12,483</b>	<b>70,837</b>	<b>95,824</b>	<b>1,086,463</b>
At 30 June 2013	562,574	140,568	70,955	44,957	8,383	12,510	71,572	93,057	1,004,576
At 31 December 2013	611,027	126,289	75,465	43,364	8,262	12,505	66,642	92,398	1,035,952

NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

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

	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
of which:									
Certificates of deposit included in:									
- trading assets	-	-	-	-	-	-	-	-	-
- financial assets designated at fair value	-	-	-	-	-	-	-	-	-
- available-for-sale investments	-	388	1,707	2,922	209	-	-	7	5,233
- held-to-maturity debt securities	-	-	-	230	2,886	2,201	-	-	5,317
<b>At 30 June 2014</b>	<b>-</b>	<b>388</b>	<b>1,707</b>	<b>3,152</b>	<b>3,095</b>	<b>2,201</b>	<b>-</b>	<b>7</b>	<b>10,550</b>
At 30 June 2013	-	201	1,392	4,045	2,320	2,997	-	25	10,980
At 31 December 2013	-	692	848	2,826	2,846	2,500	-	17	9,729
Debt securities included in:									
- trading assets	-	-	-	-	-	-	24,886	-	24,886
- financial assets designated at fair value	-	-	-	-	9	51	-	-	60
- available-for-sale investments	-	32,055	58,342	58,207	43,235	2,819	-	288	194,946
- held-to-maturity debt securities	-	104	1,096	4,276	23,404	36,031	-	-	64,911
<b>At 30 June 2014</b>	<b>-</b>	<b>32,159</b>	<b>59,438</b>	<b>62,483</b>	<b>66,648</b>	<b>38,901</b>	<b>24,886</b>	<b>288</b>	<b>284,803</b>
At 30 June 2013	-	30,331	46,677	44,664	69,644	38,624	34,141	531	264,612
At 31 December 2013	-	34,547	51,846	57,455	64,532	37,256	23,807	296	269,739
Certificates of deposit in issue included in:									
- trading liabilities	-	-	-	-	-	-	-	-	-
- financial liabilities designated at fair value	-	-	-	-	-	-	-	-	-
- issued at amortised cost	-	-	-	4,660	4,000	-	-	-	8,660
<b>At 30 June 2014</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>4,660</b>	<b>4,000</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>8,660</b>
At 30 June 2013	-	-	-	6,368	4,654	-	-	-	11,022
At 31 December 2013	-	-	-	3,949	4,652	-	-	-	8,601

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

## 19 Cash and balances at central banks

	At 30 June 2014	At 30 June 2013 <i>(restated)</i>	At 31 December 2013
Cash in hand	5,496	5,782	6,005
Balances at central banks	2,225	4,016	16,712
	<u>7,721</u>	<u>9,798</u>	<u>22,717</u>

## 20 Placings with and advances to banks

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Balances with banks	7,828	5,013	10,577
Placings with and advances to banks maturing within one month	73,515	80,620	64,749
Placings with and advances to banks maturing after one month but less than one year	59,563	53,392	64,586
Placings with and advances to banks maturing after one year	2,069	1,987	2,028
	<u>142,975</u>	<u>141,012</u>	<u>141,940</u>

of which:

Placings with and advances to central banks	14,477	13,971	13,914
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There were no overdue advances, impaired advances and rescheduled advances to banks for the periods indicated.

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

## 21 Trading assets

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Treasury bills	16,108	28,206	18,336
Certificates of deposit	-	-	-
Other debt securities	8,778	5,935	5,471
Debt securities	24,886	34,141	23,807
Investment funds	35	25	28
<b>Total trading securities</b>	<b>24,921</b>	<b>34,166</b>	<b>23,835</b>
Other*	1,292	343	8,161
<b>Total trading assets</b>	<b>26,213</b>	<b>34,509</b>	<b>31,996</b>
<b>Debt securities:</b>			
- listed in Hong Kong	5,013	4,322	3,783
- listed outside Hong Kong	647	780	700
	5,660	5,102	4,483
- unlisted	19,226	29,039	19,324
	24,886	34,141	23,807
<b>Investment funds:</b>			
- listed in Hong Kong	35	25	28
<b>Total trading securities</b>	<b>24,921</b>	<b>34,166</b>	<b>23,835</b>
<b>Debt securities:</b>			
Issued by public bodies:			
- central governments and central banks	21,770	33,077	22,650
- other public sector entities	-	69	-
	21,770	33,146	22,650
Issued by other bodies:			
- banks	627	581	853
- corporate entities	2,489	414	304
	3,116	995	1,157
	24,886	34,141	23,807
<b>Investment funds:</b>			
Issued by corporate entities	35	25	28
<b>Total trading securities</b>	<b>24,921</b>	<b>34,166</b>	<b>23,835</b>

\* This represents the amount receivable from counterparties on trading transactions not yet settled.

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

## 22 Financial assets designated at fair value

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Certificates of deposit	-	-	-
Other debt securities	60	4,228	812
Debt securities	60	4,228	812
Equity shares	7,015	2,990	3,639
Investment funds	3,256	2,932	2,536
	<b>10,331</b>	<b>10,150</b>	<b>6,987</b>
<b>Debt securities:</b>			
- listed in Hong Kong	11	87	103
- listed outside Hong Kong	49	468	489
	60	555	592
- unlisted	-	3,673	220
	60	4,228	812
<b>Equity shares:</b>			
- listed in Hong Kong	2,299	1,554	2,072
- listed outside Hong Kong	4,634	1,408	1,539
	6,933	2,962	3,611
- unlisted	82	28	28
	7,015	2,990	3,639
<b>Investment funds:</b>			
- listed in Hong Kong	509	27	32
- listed outside Hong Kong	341	741	314
	850	768	346
- unlisted	2,406	2,164	2,190
	3,256	2,932	2,536
	<b>10,331</b>	<b>10,150</b>	<b>6,987</b>
<b>Debt securities:</b>			
Issued by public bodies:			
- central governments and central banks	-	313	358
- other public sector entities	1	46	44
	1	359	402
Issued by other bodies:			
- banks	10	3,664	208
- corporate entities	49	205	202
	59	3,869	410
	60	4,228	812
<b>Equity shares:</b>			
Issued by banks	903	499	634
Issued by public sector entities	13	12	12
Issued by corporate entities	6,099	2,479	2,993
	7,015	2,990	3,639
<b>Investment funds:</b>			
Issued by banks	82	-	-
Issued by corporate entities	3,174	2,932	2,536
	3,256	2,932	2,536
	<b>10,331</b>	<b>10,150</b>	<b>6,987</b>

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

## 23 Derivative financial instruments

Derivative financial instruments are held for trading, as financial instruments designated at fair value, or designated as either fair value hedges or cash flow hedges. The Group primarily traded over-the-counter derivatives and also participated in exchange traded derivatives. The following table shows the nominal contract amounts and marked-to-market value of assets and liabilities by class of derivatives.

	At 30 June 2014			At 30 June 2013			At 31 December 2013		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
<b>Derivatives held for trading</b>									
Exchange rate contracts:									
- spot and forward foreign exchange	629,467	2,314	1,816	543,255	1,802	1,749	590,846	4,066	2,849
- currency swaps	14,228	84	104	3,095	6	16	1,742	4	10
- currency options purchased	131,403	2,373	-	170,110	697	-	104,145	183	-
- currency options written	132,098	-	2,350	171,862	-	686	105,366	-	160
- other exchange rate contracts	-	-	-	37	-	-	-	-	-
	<u>907,196</u>	<u>4,771</u>	<u>4,270</u>	<u>888,359</u>	<u>2,505</u>	<u>2,451</u>	<u>802,099</u>	<u>4,253</u>	<u>3,019</u>
Interest rate contracts:									
- interest rate swaps	190,648	878	764	215,351	1,256	1,060	193,275	1,553	1,348
- other interest rate contracts	1,539	2	-	582	1	1	78	-	-
	<u>192,187</u>	<u>880</u>	<u>764</u>	<u>215,933</u>	<u>1,257</u>	<u>1,061</u>	<u>193,353</u>	<u>1,553</u>	<u>1,348</u>
Equity and other contracts:									
- equity swaps	1,933	10	14	3,143	1	207	2,883	16	109
- equity options purchased	4,455	99	-	8,601	95	-	3,161	44	-
- equity options written	3,424	-	50	2,057	-	80	2,979	-	42
- other equity contracts	2,263	-	24	-	-	-	-	-	-
- spot and forward contracts and others	1,198	47	2	1,816	7	24	965	4	7
	<u>13,273</u>	<u>156</u>	<u>90</u>	<u>15,617</u>	<u>103</u>	<u>311</u>	<u>9,988</u>	<u>64</u>	<u>158</u>
Total derivatives held for trading	<u>1,112,656</u>	<u>5,807</u>	<u>5,124</u>	<u>1,119,909</u>	<u>3,865</u>	<u>3,823</u>	<u>1,005,440</u>	<u>5,870</u>	<u>4,525</u>
<b>Derivatives managed in conjunction with financial assets designated at fair value</b>									
Interest rate contracts:									
- interest rate swaps	-	-	-	-	-	-	-	-	-
<b>Cash flow hedge derivatives</b>									
Exchange rate contracts:									
- currency swaps	2,659	417	9	4,992	793	38	3,463	667	6
Interest rate contracts:									
- interest rate swaps	9,200	9	6	7,122	9	4	3,100	5	2
	<u>11,859</u>	<u>426</u>	<u>15</u>	<u>12,114</u>	<u>802</u>	<u>42</u>	<u>6,563</u>	<u>672</u>	<u>8</u>
<b>Fair value hedge derivatives</b>									
Interest rate contracts:									
- interest rate swaps	30,167	63	686	28,677	85	952	29,149	104	713
Total derivatives	<u>1,154,682</u>	<u>6,296</u>	<u>5,825</u>	<u>1,160,700</u>	<u>4,752</u>	<u>4,817</u>	<u>1,041,152</u>	<u>6,646</u>	<u>5,246</u>

The above derivative assets and liabilities, being the positive or negative marked-to-market value of the respective derivative contracts, represent gross replacement costs.



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

## 24 Loans and advances to customers

### (a) Loans and advances to customers

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Gross loans and advances to customers	634,413	581,080	587,688
Less: loan impairment allowances			
- individually assessed	(721)	(666)	(709)
- collectively assessed	(745)	(709)	(739)
	<u>632,947</u>	<u>579,705</u>	<u>586,240</u>

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

	At 30 June 2014 %	At 30 June 2013 %	At 31 December 2013 %
Loan impairment allowances:			
- individually assessed	0.11	0.11	0.12
- collectively assessed	0.12	0.12	0.13
Total loan impairment allowances	<u>0.23</u>	<u>0.23</u>	<u>0.25</u>

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

	Individually assessed	Collectively assessed	Total
At 1 January 2014	709	739	1,448
Amounts written off	(70)	(269)	(339)
Recoveries of loans and advances written off in previous years	31	27	58
New impairment allowances charged to income statement (note 11)	179	284	463
Impairment allowances released to income statement (note 11)	(122)	(32)	(154)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(3)	(2)	(5)
Exchange	(3)	(2)	(5)
At 30 June 2014	<u>721</u>	<u>745</u>	<u>1,466</u>
At 1 January 2013	681	728	1,409
Amounts written off	(18)	(246)	(264)
Recoveries of loans and advances written off in previous years	7	24	31
New impairment allowances charged to income statement (note 11)	61	324	385
Impairment allowances released to income statement (note 11)	(64)	(123)	(187)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(3)	(1)	(4)
Exchange	2	3	5
At 30 June 2013	<u>666</u>	<u>709</u>	<u>1,375</u>
At 1 July 2013	666	709	1,375
Amounts written off	(51)	(248)	(299)
Recoveries of loans and advances written off in previous years	9	28	37
New impairment allowances charged to income statement (note 11)	130	279	409
Impairment allowances released to income statement (note 11)	(43)	(28)	(71)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(2)	(3)	(5)
Exchange	-	2	2
At 31 December 2013	<u>709</u>	<u>739</u>	<u>1,448</u>

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

## 24 Loans and advances to customers (continued)

### (c) Impaired loans and advances to customers and allowances

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Gross impaired loans and advances	1,292	1,289	1,311
Individually assessed allowances	(721)	(666)	(709)
	<u>571</u>	<u>623</u>	<u>602</u>
Individually assessed allowances as a percentage of gross impaired loans and advances	<u>55.8%</u>	<u>51.7%</u>	<u>54.1%</u>
Gross impaired loans and advances as a percentage of gross loans and advances to customers	<u>0.20%</u>	<u>0.22%</u>	<u>0.22%</u>

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

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Gross individually assessed impaired loans and advances	1,124	1,131	1,157
Individually assessed allowances	(721)	(666)	(709)
	<u>403</u>	<u>465</u>	<u>448</u>
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	<u>0.18%</u>	<u>0.19%</u>	<u>0.20%</u>
Amount of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	<u>299</u>	<u>407</u>	<u>516</u>

Collateral includes any tangible security that carries a fair market value and is readily marketable. This includes (but is not limited to) cash and deposits, stocks and bonds, mortgages over properties and charges over other fixed assets such as plant and equipment. Where collateral values are greater than gross loans and advances to customers, only the amount of collateral up to the gross loans and advances is included.

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

## 24 Loans and advances to customers (continued)

### (d) Overdue loans and advances to customers

Loans and advances to customers that are more than three months overdue and their expression as a percentage of gross loans and advances to customers are as follows:

	At 30 June 2014 %	At 30 June 2013 %	At 31 December 2013 %
Gross loans and advances which have been overdue with respect to either principal or interest for periods of:			
- more than three months but not more than six months	168 -	140 -	121 -
- more than six months but not more than one year	100 -	50 -	73 -
- more than one year	640 0.1	681 0.1	637 0.1
	<b>908 0.1</b>	<b>871 0.1</b>	<b>831 0.1</b>

of which:

- individually impaired allowances	(543)	(564)	(583)
- covered portion of overdue loans and advances	226	293	298
- uncovered portion of overdue loans and advances	682	578	533
- current market value of collateral held against the covered portion of overdue loans and advances	533	850	599

Collateral held with respect to overdue loans and advances is mainly residential properties and commercial properties. The current market value of residential properties and commercial properties were HK\$381m and HK\$87m respectively.

Loans and advances with a specific repayment date are classified as overdue when the principal or interest is overdue and remains unpaid at the period-end. Loans and advances repayable by regular instalments are treated as overdue when an instalment payment is overdue and remains unpaid at the period-end. Loans and advances repayable on demand are classified as overdue either when a demand for repayment has been served on the borrower but repayment has not been made in accordance with the demand notice, or when the loans and advances have remained continuously outside the approved limit advised to the borrower for more than the overdue period in question.

### (e) Rescheduled loans and advances to customers

Rescheduled loans and advances to customers and their expression as a percentage of gross loans and advances to customers are as follows:

	At 30 June 2014 %	At 30 June 2013 %	At 31 December 2013 %
Rescheduled loans and advances to customers	139 -	167 -	123 -

Rescheduled loans and advances to customers are those loans and advances that have been rescheduled or renegotiated for reasons related to the borrower's financial difficulties. This will normally involve the granting of concessionary terms and resetting the overdue account to non-overdue status.

Rescheduled loans and advances to customers are stated net of any advances which have subsequently become overdue for more than three months and which are included in "Overdue loans and advances to customers" (note 24d).

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

**24 Loans and advances to customers** (continued)

**(f) Segmental analysis of loans and advances to customers by geographical area**

Loans and advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when a loan is guaranteed by a party located in an area that is different from that of the counterparty.

	Gross loans and advances	Individually impaired loans and advances	Overdue loans and advances	Individually assessed allowances	Collectively assessed allowances
<b>At 30 June 2014</b>					
Hong Kong	527,996	869	828	530	615
Rest of Asia-Pacific	99,370	253	78	191	121
Others	7,047	2	2	-	9
	<u>634,413</u>	<u>1,124</u>	<u>908</u>	<u>721</u>	<u>745</u>
<b>At 30 June 2013</b>					
Hong Kong	467,327	886	715	498	545
Rest of Asia-Pacific	106,461	212	150	163	153
Others	7,292	33	6	5	11
	<u>581,080</u>	<u>1,131</u>	<u>871</u>	<u>666</u>	<u>709</u>
<b>At 31 December 2013</b>					
Hong Kong	480,545	924	642	527	589
Rest of Asia-Pacific	99,987	233	189	182	140
Others	7,156	-	-	-	10
	<u>587,688</u>	<u>1,157</u>	<u>831</u>	<u>709</u>	<u>739</u>

**(g) Gross loans and advances to customers by industry sector**

The analysis of gross loans and advances to customers by industry sector based on categories and definitions used by the HKMA is as follows:

	At 30 June 2014		At 30 June 2013		At 31 December 2013	
	% of gross advances covered by collateral		% of gross advances covered by collateral		% of gross advances covered by collateral	
<b>Gross loans and advances to customers for use in Hong Kong</b>						
<b>Industrial, commercial and financial sectors</b>						
- property development	42,019	36.2	28,551	47.2	30,529	47.2
- property investment	111,550	92.0	99,722	90.0	100,912	90.6
- financial concerns	3,709	67.2	4,566	39.5	2,773	46.4
- stockbrokers	2,937	5.1	402	33.9	304	46.2
- wholesale and retail trade	24,979	52.1	19,850	48.4	21,912	46.5
- manufacturing	20,811	51.0	17,252	36.6	17,372	37.6
- transport and transport equipment	7,306	62.5	6,072	67.6	6,289	67.8
- recreational activities	137	9.0	224	35.3	160	15.5
- information technology	1,581	35.1	1,968	39.7	1,870	43.4
- other	35,958	52.1	32,751	52.6	35,664	53.4
	<u>250,987</u>	<u>66.9</u>	<u>211,358</u>	<u>67.8</u>	<u>217,785</u>	<u>68.0</u>
<b>Individuals</b>						
- loans and advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	14,972	100.0	13,619	100.0	14,452	100.0
- loans and advances for the purchase of other residential properties	134,413	100.0	129,733	100.0	131,305	100.0
- credit card loans and advances	21,554	-	20,081	-	21,419	-
- other	17,265	47.3	14,333	24.9	14,431	41.6
	<u>188,204</u>	<u>83.7</u>	<u>177,766</u>	<u>82.6</u>	<u>181,607</u>	<u>83.6</u>
<b>Total gross loans and advances for use in Hong Kong</b>	439,191	74.1	389,124	74.6	399,392	75.1
<b>Trade finance</b>	51,737	24.0	62,892	15.3	52,117	19.6
<b>Gross loans and advances for use outside Hong Kong</b>	143,485	26.3	129,064	31.8	136,179	29.4
<b>Gross loans and advances to customers</b>	<u>634,413</u>	<u>59.2</u>	<u>581,080</u>	<u>58.7</u>	<u>587,688</u>	<u>59.6</u>

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

## 25 Financial investments

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Financial investments:			
- which may be repledged or resold by counterparties	313	230	96
- which may not be repledged or resold or are not subject to repledge or resale by counterparties	296,990	263,139	282,749
	<u>297,303</u>	<u>263,369</u>	<u>282,845</u>
Held-to-maturity debt securities at amortised cost	70,228	70,935	71,505
Available-for-sale at fair value:			
- debt securities	200,179	166,288	183,344
- equity shares	26,851	26,103	27,948
- investment funds	45	43	48
	<u>297,303</u>	<u>263,369</u>	<u>282,845</u>
Treasury bills	105,192	75,014	91,811
Certificates of deposit	10,550	10,980	9,729
Other debt securities	154,665	151,229	153,309
Debt securities	<u>270,407</u>	<u>237,223</u>	<u>254,849</u>
Equity shares	26,851	26,103	27,948
Investment funds	45	43	48
	<u>297,303</u>	<u>263,369</u>	<u>282,845</u>

There were no overdue debt securities at 30 June 2014 and the comparative periods for the Group. The Group did not hold any asset-backed securities, mortgage-backed securities and collateralised debt obligations.

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

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Listed in Hong Kong	1,871	1,431	1,447
Listed outside Hong Kong	13,386	13,964	14,749
	<u>15,257</u>	<u>15,395</u>	<u>16,196</u>
Unlisted	54,971	55,540	55,309
	<u>70,228</u>	<u>70,935</u>	<u>71,505</u>
Issued by public bodies:			
- central governments and central banks	547	1,164	1,168
- other public sector entities	10,855	11,184	11,129
	<u>11,402</u>	<u>12,348</u>	<u>12,297</u>
Issued by other bodies:			
- banks	31,521	33,811	32,252
- corporate entities	27,305	24,776	26,956
	<u>58,826</u>	<u>58,587</u>	<u>59,208</u>
	<u>70,228</u>	<u>70,935</u>	<u>71,505</u>
Fair value of held-to-maturity debt securities:			
- listed	15,917	15,706	16,419
- unlisted	55,836	56,680	55,595
	<u>71,753</u>	<u>72,386</u>	<u>72,014</u>

There were no held-to-maturity debt securities determined to be impaired at 30 June 2014 and the comparative periods for the Group.

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

### 25 Financial investments (continued)

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

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Listed in Hong Kong	12,174	11,245	10,262
Listed outside Hong Kong	51,767	45,012	53,029
	<u>63,941</u>	<u>56,257</u>	<u>63,291</u>
Unlisted	136,238	110,031	120,053
	<u>200,179</u>	<u>166,288</u>	<u>183,344</u>
Issued by public bodies:			
- central governments and central banks	147,646	108,930	126,431
- other public sector entities	15,826	16,471	16,551
	<u>163,472</u>	<u>125,401</u>	<u>142,982</u>
Issued by other bodies:			
- banks	33,371	37,049	36,937
- corporate entities	3,336	3,838	3,425
	<u>36,707</u>	<u>40,887</u>	<u>40,362</u>
	<u>200,179</u>	<u>166,288</u>	<u>183,344</u>

For the periods indicated, there were no available-for-sale debt securities individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities for the Group.

#### (c) Available-for-sale equity shares

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Listed in Hong Kong	69	65	67
Listed outside Hong Kong	25,946	25,753	26,897
	<u>26,015</u>	<u>25,818</u>	<u>26,964</u>
Unlisted	836	285	984
	<u>26,851</u>	<u>26,103</u>	<u>27,948</u>
Issued by banks	26,441	25,753	27,510
Issued by corporate entities	410	350	438
	<u>26,851</u>	<u>26,103</u>	<u>27,948</u>

For the periods indicated, there were no available-for-sale equity securities individually determined to be impaired for the Group. Available-for-sale financial investments are tested for impairment when there is an indication that the investment may be impaired. The Group's policy is to recognise an impairment loss where there is a "significant" or "prolonged" decline in the fair value of an equity investment. At 30 June 2014, the fair value of the Bank's investment in Industrial Bank, an "available-for-sale" financial investment, was HK\$25.9bn, 10% below the deemed cost of HK\$28.8bn. In accordance with the Group's policy, no impairment loss has been recognised at 30 June 2014. If the fair value remains below the deemed cost in the second half of 2014, an impairment loss may be recognised in the income statement. In subsequent periods, any further declines in fair value below the level at which the initial impairment loss was recognised, may be reflected in the income statement for the relevant period as additional impairment losses.

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

## 25 Financial investments (continued)

### (d) Available-for-sale investment funds

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Unlisted	<u>45</u>	<u>43</u>	<u>48</u>
Issued by corporate entities	<u>45</u>	<u>43</u>	<u>48</u>

For the periods indicated, there were no available-for-sale investment funds individually determined to be impaired for the Group.

- (e) The following table presents an analysis of debt securities by rating agency designation at the balance sheet dates, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

	At 30 June 2014	At 30 June 2013	At 31 December 2013
AA- to AAA	201,920	184,183	187,387
A- to A+	59,592	43,799	59,463
B+ to BBB+	6,765	6,872	5,714
Unrated	<u>2,130</u>	<u>2,369</u>	<u>2,285</u>
	<u>270,407</u>	<u>237,223</u>	<u>254,849</u>

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## 26 Interest in associates

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Share of net assets	2,178	2,597	2,062
Intangible assets	-	15	-
Goodwill	-	141	-
	<u>2,178</u>	<u>2,753</u>	<u>2,062</u>

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

## 27 Investment properties

	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Half-year ended 31 December 2013
Beginning of the period	10,918	4,860	10,547
Additions	-	4,683	184
Surplus on revaluation credited to income statement	261	1,147	191
Transfer to premises (note 28)	(71)	(143)	(4)
End of the period	<u>11,108</u>	<u>10,547</u>	<u>10,918</u>
Representing:			
- measure at valuation	<u>11,108</u>	<u>10,547</u>	<u>10,918</u>

## 28 Premises, plant and equipment

### Movement of premises, plant and equipment

	Premises	Plant and equipment	Total
Cost or valuation:			
At 1 January 2014	20,496	3,856	24,352
Additions	-	342	342
Disposals	-	(182)	(182)
Elimination of accumulated depreciation on revalued premises	(300)	-	(300)
Surplus on revaluation:			
- credited to premises revaluation reserve	612	-	612
- debited to income statement	-	-	-
Transfer from investment properties (note 27)	71	-	71
Exchange adjustments	(14)	(11)	(25)
At 30 June 2014	<u>20,865</u>	<u>4,005</u>	<u>24,870</u>
Accumulated depreciation:			
At 1 January 2014	-	(3,352)	(3,352)
Charge for the period (note 12)	(300)	(106)	(406)
Written off on disposal	-	174	174
Elimination of accumulated depreciation on revalued premises	300	-	300
Exchange adjustments	-	8	8
At 30 June 2014	<u>-</u>	<u>(3,276)</u>	<u>(3,276)</u>
Net book value at 30 June 2014	<u>20,865</u>	<u>729</u>	<u>21,594</u>
Representing:			
- measure at cost	-	729	729
- measure at valuation	<u>20,865</u>	<u>-</u>	<u>20,865</u>
	<u>20,865</u>	<u>729</u>	<u>21,594</u>



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

## 28 Premises, plant and equipment (continued)

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

	Premises	Plant and equipment	Total
Cost or valuation:			
At 1 January 2013	18,748	3,751	22,499
Additions	36	94	130
Disposals	(3)	(71)	(74)
Elimination of accumulated depreciation on revalued premises	(266)	-	(266)
Surplus on revaluation:			
- credited to premises revaluation reserve	1,526	-	1,526
- debited to income statement	(3)	-	(3)
Transfer from investment properties (note 27)	143	-	143
Exchange adjustments and other	15	12	27
At 30 June 2013	<u>20,196</u>	<u>3,786</u>	<u>23,982</u>
Accumulated depreciation:			
At 1 January 2013	-	(3,237)	(3,237)
Charge for the period (note 12)	(266)	(110)	(376)
Written off on disposal	-	63	63
Elimination of accumulated depreciation on revalued premises	266	-	266
Exchange adjustments	-	(8)	(8)
At 30 June 2013	<u>-</u>	<u>(3,292)</u>	<u>(3,292)</u>
Net book value at 30 June 2013	<u>20,196</u>	<u>494</u>	<u>20,690</u>
Representing:			
- measure at cost	-	494	494
- measure at valuation	<u>20,196</u>	<u>-</u>	<u>20,196</u>
	<u>20,196</u>	<u>494</u>	<u>20,690</u>
Cost or valuation:			
At 1 July 2013	20,196	3,786	23,982
Additions	-	109	109
Disposals	-	(46)	(46)
Elimination of accumulated depreciation on revalued premises	(290)	-	(290)
Surplus on revaluation:			
- credited to premises revaluation reserve	577	-	577
Transfer to investment properties (note 27)	4	-	4
Exchange adjustments and other	9	7	16
At 31 December 2013	<u>20,496</u>	<u>3,856</u>	<u>24,352</u>
Accumulated depreciation:			
At 1 July 2013	-	(3,292)	(3,292)
Charge for the period (note 12)	(290)	(96)	(386)
Written off on disposal	-	43	43
Elimination of accumulated depreciation on revalued premises	290	-	290
Exchange adjustments	-	(7)	(7)
At 31 December 2013	<u>-</u>	<u>(3,352)</u>	<u>(3,352)</u>
Net book value at 31 December 2013	<u>20,496</u>	<u>504</u>	<u>21,000</u>
Representing:			
- measure at cost	-	504	504
- measure at valuation	<u>20,496</u>	<u>-</u>	<u>20,496</u>
	<u>20,496</u>	<u>504</u>	<u>21,000</u>

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

### 29 Intangible assets

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Present value of in-force long-term insurance business	8,005	6,625	7,198
Internally developed software	369	390	378
Acquired software	76	59	69
Goodwill	329	329	329
	<u>8,779</u>	<u>7,403</u>	<u>7,974</u>

### 30 Other assets

	At 30 June 2014	At 30 June 2013 (restated)	At 31 December 2013
Items in the course of collection from other banks	6,912	5,540	4,743
Bullion	3,392	4,379	4,184
Prepayments and accrued income	3,972	3,245	3,519
Assets held for sale	5	4	9
Acceptances and endorsements	6,928	6,057	6,351
Retirement benefit assets	38	42	40
Other accounts	4,963	2,702	3,559
	<u>26,210</u>	<u>21,969</u>	<u>22,405</u>

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

Gold bullion balances were reclassified from "Cash and balances at central banks" to "Other assets" in the second half of 2013 to reflect better the substance of the gold lending business. 30 June 2013 comparatives have been restated accordingly.

### 31 Current, savings and other deposit accounts

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Current, savings and other deposit accounts:			
- as stated in consolidated balance sheet	860,092	779,884	824,996
- structured deposits reported as trading liabilities (note 32)	47,042	39,990	34,489
	<u>907,134</u>	<u>819,874</u>	<u>859,485</u>
By type:			
- demand and current accounts	73,367	68,142	74,664
- savings accounts	525,172	483,341	526,403
- time and other deposits	308,595	268,391	258,418
	<u>907,134</u>	<u>819,874</u>	<u>859,485</u>

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

### 32 Trading liabilities

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Structured certificates of deposit in issue (note 33)	-	-	-
Other structured debt securities in issue (note 33)	3,743	1,312	1,615
Structured deposits (note 31)	47,042	39,990	34,489
Short positions in securities and others	14,928	26,447	26,013
	<u>65,713</u>	<u>67,749</u>	<u>62,117</u>

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

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Certificates of deposit and other debt securities in issue:			
- as stated in consolidated balance sheet	9,904	11,022	8,601
- structured certificates of deposit in issue reported as trading liabilities (note 32)	-	-	-
- other structured debt securities in issue reported as trading liabilities (note 32)	3,743	1,312	1,615
	<u>13,647</u>	<u>12,334</u>	<u>10,216</u>
By type:			
- certificates of deposit in issue	8,660	11,022	8,601
- other debt securities in issue	4,987	1,312	1,615
	<u>13,647</u>	<u>12,334</u>	<u>10,216</u>

### 34 Other liabilities

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Items in the course of transmission to other banks	8,759	8,034	6,987
Accruals	3,247	3,052	3,330
Acceptances and endorsements	6,956	6,057	6,351
Retirement benefit liabilities	1,768	1,682	1,772
Other	3,721	2,049	2,027
	<u>24,451</u>	<u>20,874</u>	<u>20,467</u>

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

### 35 Subordinated liabilities

		At 30 June 2014	At 30 June 2013	At 31 December 2013
Nominal value	Description			
<b>Amount owed to HSBC Group undertakings</b>				
US\$775m	Floating rate subordinated loan debt due December 2020 <sup>(1)</sup>	<b>6,007</b>	6,011	6,009
US\$450m	Floating rate subordinated loan debt due July 2021 <sup>(2)</sup>	<b>3,488</b>	3,491	3,489
US\$300m	Floating rate subordinated loan debt due July 2022 <sup>(3)</sup>	<b>2,325</b>	2,327	2,326
		<b>11,820</b>	11,829	11,824
Representing:				
- measured at amortised cost		<b>11,820</b>	11,829	11,824

<sup>(1)</sup> Interest rate at three-month US dollar LIBOR plus 1.79 per cent, payable quarterly, to the maturity date.

<sup>(2)</sup> Interest rate at three-month US dollar LIBOR plus 2.05 per cent, payable quarterly, to the maturity date.

<sup>(3)</sup> Interest rate at three-month US dollar LIBOR plus 4.06 per cent, payable quarterly, to the maturity date.

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

The Group has not had any defaults of principal, interest or other breaches with respect to its debt securities for the periods indicated.

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

## 36 Shareholders' funds

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Share capital	9,658	9,559	9,559
Retained profits	83,215	76,633	78,679
Premises revaluation reserve	15,200	14,628	14,904
Cash flow hedging reserve	3	2	6
Available-for-sale investment reserve			
- on debt securities	136	(141)	(113)
- on equity securities	(2,596)	(2,743)	(1,505)
Capital redemption reserve	-	99	99
Other reserves	1,782	1,941	1,943
Total reserves	97,740	90,419	94,013
Proposed dividends	107,398	99,978	103,572
Shareholders' funds	2,103	2,103	4,206
	109,501	102,081	107,778
Return on average shareholders' funds*	15.9%	35.9%	15.3%

\* For the half-year ended

The capital redemption reserve of HK\$99m had been included in share capital under the Hong Kong New Companies Ordinance (Cap. 622) which became effective on 3 March 2014. Please refer to the section "The New Hong Kong Companies Ordinance (Cap. 622)" in note 41 for details.

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a "regulatory reserve" directly from retained profits. As at 30 June 2014, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group to shareholders by HK\$6,063m (HK\$5,213m and HK\$5,440m at 30 June 2013 and 31 December 2013 respectively).

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

## 37 Reconciliation of cash flow statement

### (a) Reconciliation of operating profit to net cash flow from operating activities

	Half-year ended 30 June 2014	Half-year ended 30 June 2013 (restated)
Operating profit	9,496	8,934
Net interest income	(9,671)	(8,969)
Dividend income	(5)	(4)
Loan impairment charges and other credit risk provisions	337	198
Depreciation	406	376
Amortisation of intangible assets	55	57
Amortisation of available-for-sale investments	20	49
Loans and advances written off net of recoveries	(281)	(233)
Movement in present value of in-force long-term insurance business	(807)	(622)
Interest received	12,439	10,794
Interest paid	(3,088)	(2,306)
<b>Operating profit before changes in working capital</b>	<b>8,901</b>	<b>8,274</b>
Change in treasury bills and certificates of deposit with original maturity more than three months	(18,983)	7,728
Change in placings with and advances to banks maturing after one month	5,023	7,923
Change in trading assets	6,541	2,537
Change in derivative financial instruments	929	1,126
Change in reverse repurchase agreements - non trading	(2,309)	-
Change in loans and advances to customers	(46,464)	(43,428)
Change in other assets	(4,376)	(3,925)
Change in current, savings and other deposit accounts	35,094	10,737
Change in repurchase agreements - non trading	1,837	1,625
Change in deposits from banks	(491)	(5,726)
Change in trading liabilities	3,596	7,896
Change in certificates of deposit and other debt securities in issue	1,303	(269)
Change in other liabilities	4,485	3,660
Elimination of exchange differences and other non-cash items	(1,774)	5,444
<b>Cash (used in)/generated from operating activities</b>	<b>(6,688)</b>	<b>3,602</b>
Taxation (paid)/recovered	(145)	5
<b>Net cash (outflow)/inflow from operating activities</b>	<b>(6,833)</b>	<b>3,607</b>

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

	At 30 June 2014	At 30 June 2013 (restated)
Cash and balances at central banks	7,721	9,798
Balances with banks	7,828	5,013
Items in the course of collection from other banks	6,912	5,540
Placings with and advances to banks maturing within one month	69,933	78,729
Treasury bills	18,592	9,931
Certificates of deposit	-	-
Less: items in the course of transmission to other banks	(8,759)	(8,034)
	<b>102,227</b>	<b>100,977</b>

The balances of cash and cash equivalents included cash balances with central banks and placings with banks maturing within one month that are subject to exchange control and regulatory restrictions, amounting to HK\$21,472m at 30 June 2014 (HK\$21,972m at 30 June 2013).

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

### 38 Contingent liabilities, commitments and derivatives

The table below gives the nominal contract amounts, credit equivalent amounts and risk-weighted amounts of contingent liabilities, commitments and derivative transactions. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the HKMA by the Group. The return is prepared on a consolidated basis as specified by the HKMA under the requirement of section 3C(1) of the Banking (Capital) Rules.

For accounting purposes, acceptances and endorsements are recognised on the balance sheet in "Other assets" and "Other Liabilities" in accordance with HKAS 39 "Financial Instruments: Recognition and Measurement". For the purpose of the Banking (Capital) Rules ("the Capital Rules"), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables were HK\$6,956m (HK\$6,057m and HK\$6,351m at 30 June 2013 and 31 December 2013 respectively).

Contingent liabilities and commitments are credit-related instruments. Contractual amounts represent the amounts at risk should contracts be fully drawn upon and clients default. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contractual amounts is not representative of expected future liquidity requirements.

Derivatives arise from futures, forward, swap and option transactions undertaken by the Group in the foreign exchange, interest rate, equity, credit and commodity markets. The contract amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Capital Rules and depend on the status of the counterparty and maturity characteristics of the instrument.

The netting benefits represent amounts where the Group has in place legally enforceable rights of offset with individual counterparties to offset the gross amount of positive mark-to-market assets with any negative mark-to-market liabilities with the same customer. These offsets are recognised by the HKMA in the calculation of risk-weighted amounts for the capital adequacy ratio.

The risk-weighted assets were calculated based on the "advanced internal ratings-based approach".

	At 30 June 2014	At 30 June 2013	At 31 December 2013
Direct credit substitutes	11,905	6,973	8,977
Transaction-related contingencies	2,097	1,546	1,821
Trade-related contingencies	16,063	14,443	14,922
Forward asset purchases	34	32	43
Commitments that are unconditionally cancellable without prior notice	256,666	247,537	243,895
Commitments which have an original maturity of not more than one year	4,283	6,652	3,723
Commitments which have an original maturity of more than one year	23,000	27,469	24,620
<b>Contract amounts</b>	<b>314,048</b>	<b>304,652</b>	<b>298,001</b>
<b>Risk-weighted amounts</b>	<b>32,290</b>	<b>33,336</b>	<b>30,818</b>
	<b>Contract amount</b>	<b>Credit equivalent amounts</b>	<b>Risk- weighted amount</b>
<b>At 30 June 2014</b>			
Exchange rate contracts:			
- spot and forward foreign exchange	547,644	3,589	1,207
- currency swaps	15,161	597	117
- currency options purchased	131,254	7,112	6,688
- other exchange rate contracts	-	-	-
	<b>694,059</b>	<b>11,298</b>	<b>8,012</b>
Interest rate contracts:			
- interest rate swaps	230,015	1,370	447
- interest rate options purchased	-	-	-
- other interest rate contracts	981	-	-
	<b>230,996</b>	<b>1,370</b>	<b>447</b>
Equity and other contracts:			
- equity swaps	1,933	126	23
- equity options purchased	3,447	260	185
- others	149	13	4
	<b>5,529</b>	<b>399</b>	<b>212</b>

The total fair value of the derivatives at 30 June 2014 was HK\$3,852m (30 June 2013: HK\$2,439m, 31 December 2013: HK\$3,093m) after taking into account the effect of valid bilateral netting agreement amounting to HK\$2,003m (30 June 2013: HK\$1,780m, 31 December 2013: HK\$3,103m).

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

**38 Contingent liabilities, commitments and derivatives** *(continued)*

	Contract amounts	Credit equivalent amounts	Risk- weighted amounts
At 30 June 2013			
Exchange rate contracts:			
- spot and forward foreign exchange	449,358	2,740	777
- currency swaps	7,336	672	98
- currency options purchased	170,110	6,045	5,556
- other exchange rate contracts	37	1	-
	<u>626,841</u>	<u>9,458</u>	<u>6,431</u>
Interest rate contracts:			
- interest rate swaps	251,150	1,802	555
- interest rate options purchased	-	-	-
- other interest rate contracts	194	-	-
	<u>251,344</u>	<u>1,802</u>	<u>555</u>
Equity and other contracts:			
- equity swaps	3,143	192	25
- equity options purchased	2,055	199	157
- others	-	-	-
	<u>5,198</u>	<u>391</u>	<u>182</u>
At 31 December 2013			
Exchange rate contracts:			
- spot and forward foreign exchange	537,659	4,414	1,133
- currency swaps	3,991	742	86
- currency options purchased	104,218	2,909	2,484
- other exchange rate contracts	14	-	-
	<u>645,882</u>	<u>8,065</u>	<u>3,703</u>
Interest rate contracts:			
- interest rate swaps	225,524	2,021	626
- interest rate options purchased	-	-	-
- other interest rate contracts	78	-	-
	<u>225,602</u>	<u>2,021</u>	<u>626</u>
Equity and other contracts:			
- equity swaps	2,883	190	24
- equity options purchased	3,161	233	164
- others	-	-	-
	<u>6,044</u>	<u>423</u>	<u>188</u>



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

## 39 Fair value of financial instruments

### (a) Fair value of financial instruments carried at fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following tables set out the financial instruments carried at fair value.

	Valuation techniques					
	Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Third party total	Amounts with HSBC entities *	Total
<b>Recurring fair value measurements</b>						
<b>At 30 June 2014</b>						
<b>Assets</b>						
Trading assets	21,154	5,059	-	26,213	-	26,213
Financial assets designated at fair value	8,080	1,648	603	10,331	-	10,331
Derivative financial instruments	410	5,413	18	5,841	455	6,296
Available-for-sale financial investments	139,795	86,444	836	227,075	-	227,075
<b>Liabilities</b>						
Trading liabilities	13,839	51,758	116	65,713	-	65,713
Financial liabilities designated at fair value	-	493	-	493	-	493
Derivative financial instruments	62	3,592	5	3,659	2,166	5,825
<b>At 30 June 2013</b>						
<b>Assets</b>						
Trading assets	32,894	1,615	-	34,509	-	34,509
Financial assets designated at fair value	4,195	1,982	524	6,701	3,449	10,150
Derivative financial instruments	421	3,952	2	4,375	377	4,752
Available-for-sale financial investments	110,738	81,411	285	192,434	-	192,434
<b>Liabilities</b>						
Trading liabilities	26,448	40,939	362	67,749	-	67,749
Financial liabilities designated at fair value	-	466	-	466	-	466
Derivative financial instruments	59	3,451	-	3,510	1,307	4,817
<b>At 31 December 2013</b>						
<b>Assets</b>						
Trading assets	22,146	9,850	-	31,996	-	31,996
Financial assets designated at fair value	4,531	1,956	500	6,987	-	6,987
Derivative financial instruments	414	5,622	3	6,039	607	6,646
Available-for-sale financial investments	125,701	84,655	984	211,340	-	211,340
<b>Liabilities</b>						
Trading liabilities	24,475	37,534	108	62,117	-	62,117
Financial liabilities designated at fair value	-	489	-	489	-	489
Derivative financial instruments	48	4,342	-	4,390	856	5,246

\* Included structured instruments and derivative contracts transacted with HSBC entities which were mainly classified within Level 2 of the valuation hierarchy.

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

### 39 Fair value of financial instruments (continued)

#### (a) Fair value of financial instruments carried at fair value (continued)

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

During the six months ended 30 June 2014, there were no material movements between Level 1 and Level 2.

#### Control framework

Fair values are subject to a control framework designed to ensure that they are either determined or validated by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the Group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia* :

- the extent to which prices may be expected to represent genuine traded or tradeable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

For fair values determined using a valuation model, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

To this end, ultimate responsibility for the determination of fair values lies with Finance. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring compliance with all relevant accounting standards.

#### Determination of fair value

Fair values are determined according to the following hierarchy:

##### (i) Level 1: Quoted market price

Financial instruments with quoted prices for identical instruments in active markets that the Group can access at the measurement date.

##### (ii) Level 2: Valuation technique using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

##### (iii) Level 3: Valuation technique with significant unobservable inputs

Financial instruments valued using models where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

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

### 39 Fair value of financial instruments (continued)

#### (a) Fair value of financial instruments carried at fair value (continued)

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations. A range of valuation techniques is employed, dependent upon the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analysis, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to consideration of credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. Projection utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products are dependent upon more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may impact the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates.

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgmental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit ("day 1 gain or loss") or greater than 5% of the instrument's carrying value is driven by unobservable inputs. "Unobservable" in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). All fair value adjustments are included within the levelling determination.

The types of financial instruments carried at fair values are as follows:

#### - Debt securities, Treasury and eligible bills, and Equities

These instruments are valued based on quoted market prices from an exchange, dealer, broker, industry group or pricing service, where available. Where unavailable, fair value is determined by reference to quoted market prices for similar instruments, or in the case of certain unquoted equities, valuation techniques using inputs derived from observable and unobservable market data.

#### - Structured notes

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

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

#### - Derivatives

OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon "no-arbitrage" principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some discrepancies in practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures. Finally, some inputs are not observable, but can generally be estimated from historical data or other sources.

Examples of inputs that are generally observable include foreign exchange spot and forward rates, benchmark interest rate curves and volatility surfaces for commonly traded option products. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors, such as foreign exchange rates, interest rates and equity prices.

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

### 39 Fair value of financial instruments (continued)

#### (a) Fair value of financial instruments carried at fair value (continued)

##### Fair value adjustments

Fair value adjustments are adopted when the Group considers that there are additional factors that would be considered by a market participant that are not incorporated within the valuation model. The Group classifies fair value adjustments as either "risk-related" or "model-related". The majority of these adjustments relate to Global 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.

The major fair value adjustment categories being regularly reviewed by the Group are as follow:

##### Risk-related adjustments:

##### - Bid-offer

HKFRS 13 requires use of the price within the bid-offer spread that is most representative of fair value. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the extent to which bid-offer cost would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the position.

##### - Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, there exists a range of possible values that the financial instrument or market parameter may assume and an adjustment may be necessary to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

##### - Credit valuation adjustment

The credit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the counterparty may default and that the Group may not receive the full market value of the transactions.

##### - Debit valuation adjustment

The debit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the Group may default, and that the Group may not pay full market value of the transactions.

##### Model-related adjustments:

##### - Model limitation

Models used for portfolio valuation purposes may be based upon a simplifying set of assumptions that do not capture all material market characteristics. Additionally, markets evolve, and models that were adequate in the past may require development to capture all material market characteristics in current market conditions. In these circumstances, model limitation adjustments are adopted. As model development progresses, model limitations are addressed within the valuation models and a model limitation adjustment is no longer needed.

##### - Inception profit (Day 1 P&L reserves)

Inception profit adjustments are adopted where the fair value estimated by a valuation model is based on one or more significant unobservable inputs.

#### Financial instruments measured at fair value using a valuation technique with significant unobservable inputs - Level 3

	Assets				Liabilities			
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives	
At 30 June 2014								
Private equity	836	-	603	-	-	-	-	
Structured notes	-	-	-	-	116	-	-	
Debt securities	-	-	-	-	-	-	-	
Derivatives	-	-	-	18	-	-	5	
	<u>836</u>	<u>-</u>	<u>603</u>	<u>18</u>	<u>116</u>	<u>-</u>	<u>5</u>	
At 30 June 2013								
Private equity	285	-	520	-	-	-	-	
Structured notes	-	-	-	-	362	-	-	
Debt securities	-	-	4	-	-	-	-	
Derivatives	-	-	-	2	-	-	-	
	<u>285</u>	<u>-</u>	<u>524</u>	<u>2</u>	<u>362</u>	<u>-</u>	<u>-</u>	
At 31 December 2013								
Private equity	984	-	500	-	-	-	-	
Structured notes	-	-	-	-	108	-	-	
Debt securities	-	-	-	-	-	-	-	
Derivatives	-	-	-	3	-	-	-	
	<u>984</u>	<u>-</u>	<u>500</u>	<u>3</u>	<u>108</u>	<u>-</u>	<u>-</u>	

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

**39 Fair value of financial instruments** (continued)

**(a) Fair value of financial instruments carried at fair value** (continued)

*Movement in Level 3 financial instruments*

	Assets				Liabilities		
	Available- for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2014	984	-	500	3	108	-	-
Total gains/(losses) recognised in profit or loss							
- trading income	-	-	-	15	-	-	5
- net income from other financial instruments designated at fair value	-	-	67	-	-	-	-
- gains less losses from financial investments	-	-	-	-	-	-	-
Total gains/(losses) recognised in other comprehensive income							
- fair value gains/(losses)	(148)	-	-	-	-	-	-
- exchange differences	-	-	-	-	-	-	-
Purchases	-	-	134	-	-	-	-
Issues/ deposit taking	-	-	-	-	115	-	-
Sales	-	-	-	-	-	-	-
Settlements	-	-	(108)	-	(87)	-	-
Transfers out	-	-	-	-	(20)	-	-
Transfers in	-	-	10	-	-	-	-
At 30 June 2014	836	-	603	18	116	-	5
Unrealised gains/(losses) recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period							
- trading income	-	-	-	18	-	-	(5)
- net income from other financial instruments designated at fair value	-	-	67	-	-	-	-

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

**39 Fair value of financial instruments** (continued)

**(a) Fair value of financial instruments carried at fair value** (continued)

*Movement in Level 3 financial instruments (continued)*

	Assets				Liabilities		
	Available- for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2013	224	-	478	161	135	-	-
Total gains/(losses) recognised in profit or loss							
- trading income	-	-	-	(82)	-	-	-
- net income from other financial instruments designated at fair value	-	-	36	-	-	-	-
- gains less losses from financial investments	-	-	-	-	-	-	-
Total gains/(losses) recognised in other comprehensive income							
- fair value gains/(losses)	61	-	-	-	-	-	-
- exchange differences	-	-	-	-	-	-	-
Purchases	-	-	40	-	-	-	-
Issues/ deposit taking	-	-	-	-	-	-	-
Sales	-	-	(7)	-	-	-	-
Settlements	-	-	(9)	(60)	227	-	-
Transfers out	-	-	(18)	(17)	-	-	-
Transfers in	-	-	4	-	-	-	-
At 30 June 2013	<u>285</u>	<u>-</u>	<u>524</u>	<u>2</u>	<u>362</u>	<u>-</u>	<u>-</u>
Unrealised gains/(losses) recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period							
- trading income	4	-	-	2	(1)	-	-
- net income from other financial instruments designated at fair value	-	-	35	-	-	-	-

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

**39 Fair value of financial instruments** (continued)

**(a) Fair value of financial instruments carried at fair value** (continued)

*Movement in Level 3 financial instruments (continued)*

	Assets				Liabilities		
	Available- for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 July 2013	285	-	524	2	362	-	-
Total gains/(losses) recognised in profit or loss							
- trading income	-	-	-	1	-	-	-
- net income from other financial instruments designated at fair value	-	-	(9)	-	-	-	-
- gains less losses from financial investments	-	-	-	-	-	-	-
Total gains/(losses) recognised in other comprehensive income							
- fair value gains/(losses)	87	-	-	-	-	-	-
- exchange differences	-	-	-	-	-	-	-
Purchases	-	-	52	-	-	-	-
Issues/ deposit taking	-	-	-	-	87	-	-
Sales	-	-	(3)	-	-	-	-
Settlements	-	-	(28)	-	(341)	-	-
Transfers out	-	-	(36)	-	-	-	-
Transfers in	612	-	-	-	-	-	-
At 31 December 2013	<u>984</u>	<u>-</u>	<u>500</u>	<u>3</u>	<u>108</u>	<u>-</u>	<u>-</u>
Unrealised gains/(losses) recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period							
- trading income	(4)	-	-	1	1	-	-
- net income from other financial instruments designated at fair value	-	-	(10)	-	-	-	-

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

### 39 Fair value of financial instruments (continued)

#### (a) Fair value of financial instruments carried at fair value (continued)

##### Movement in Level 3 financial instruments (continued)

Transfer out of Level 3 held for trading liabilities reflects change in observability of correlation between equity and equity index during the period. In respect of financial assets designated at fair value, transfer into Level 3 was due to change in portfolio mix of private equity investments.

##### Effect of changes in significant unobservable assumptions to reasonably possible alternatives

The fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions which are not evidenced by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of these fair values to reasonably possible alternative assumptions:

##### Sensitivity of fair values to reasonably possible alternative assumptions

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
<b>At 30 June 2014</b>				
Private equity	60	(60)	75	(75)
Structured notes	-	-	-	-
Debt securities	-	-	-	-
Derivatives	-	-	-	-
	<u>60</u>	<u>(60)</u>	<u>75</u>	<u>(75)</u>
<b>At 30 June 2013</b>				
Private equity	52	(52)	19	(19)
Structured notes	-	-	-	-
Debt securities	-	-	-	-
Derivatives	-	-	-	-
	<u>52</u>	<u>(52)</u>	<u>19</u>	<u>(19)</u>
<b>At 31 December 2013</b>				
Private equity	50	(50)	91	(91)
Structured notes	-	-	-	-
Debt securities	-	-	-	-
Derivatives	-	-	-	-
	<u>50</u>	<u>(50)</u>	<u>91</u>	<u>(91)</u>

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 into 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 TO THE FINANCIAL STATEMENTS (unaudited) (continued)

### 39 Fair value of financial instruments (continued)

#### (a) Fair value of financial instruments carried at fair value (continued)

Quantitative information about significant unobservable inputs in Level 3 valuations

	Valuation technique(s)	Unobservable input(s)	Range
<b>Assets</b>			
Private equity	Net asset value	N/A	N/A
		Earnings Multiple	21 - 27
	Market-comparable approach		(30 Jun 2013: 17 - 25)
			(31 Dec 2013: 20 - 33)
		Liquidity Discount	10% - 30%
Debt securities	Broker pricing	Bid quotes	(30 Jun 2013: N/A)
			(31 Dec 2013: 10%-30%)
			N/A
Derivatives	Option model	Equity Volatility	16.90% - 34.74%
			(30 Jun 2013: 5.42% - 120.18%)
			(31 Dec 2013: 7.21% - 72.54%)
		FX Volatility	2.49% - 6.30%
			(30 Jun 2013: 10.92% - 15.21%)
Liabilities	Option model	FX Volatility	4.44% - 9.69%
			(30 Jun 2013: 8.80% - 17.49%)
			(31 Dec 2013: 6.15% - 11.65%)
		Equity and Equity Index Correlation	0.686 - 0.686
			(30 Jun 2013: 0.523-0.607)
Derivatives	Option model	FX Volatility	(31 Dec 2013: 0.508-0.588)
			2.49% - 9.52%

#### Key unobservable inputs to Level 3 financial instruments

The table above lists the key unobservable inputs to Level 3 financial instruments, and provides the range of those inputs as at 30 June 2014. A further description of the categories of key unobservable inputs is given below.

#### Private equity

The Group's private equity includes investment funds and unlisted equity shares, which are classified as designated at fair value through profit or loss or available-for-sale and are not traded in active markets. In the absence of an active market, the investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership.

Investment funds are valued using their net asset value. Higher net asset value results in higher fair value, and vice versa. Given the bespoke nature of the analysis, it is not practical to quote a range of key observable inputs.

For unlisted available-for-sale equity shares, the fair values are determined with reference to multiples of comparable listed companies, such as price/earning ratio of comparables, adjusted for a liquidity discount to reflect the fact that the shares are not actively traded. An increase in the ratio in isolation will result in favourable movement in the fair values, while an increase in liquidity discount in isolation will result in unfavourable movement.

#### Volatility

Volatility is a measure of the anticipated future variability of a market price. Volatility tends to increase in stressed market conditions, and decrease in calmer market conditions. Volatility is an important input in the pricing of options. In general, the higher the volatility, the more expensive the option will be. This reflects both the higher probability of an increased return from the option, and the potentially higher costs that the Group may incur in hedging the risks associated with the option. If option prices become more expensive, this will increase the value of the Group's long option positions (i.e. the positions in which the Group has purchased options), while the Group's short option positions (i.e. the positions in which the Group has sold options) will suffer losses.

Volatility varies by underlying reference market price, and by strike and maturity of the option. Volatility also varies over time. As a result, it is difficult to make general statements regarding volatility levels.

Certain volatilities, typically those of a longer-dated nature, are unobservable. The unobservable volatility is then estimated from observable data.

The range of unobservable volatilities quoted in the table reflects the wide variation in volatility inputs by reference market price. For any single unobservable volatility, the uncertainty in the volatility determination is significantly less than the range quoted above.

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

### 39 Fair value of financial instruments *(continued)*

#### (a) Fair value of financial instruments carried at fair value *(continued)*

##### Key unobservable inputs to Level 3 financial instruments *(continued)*

###### Correlation

Correlation is a measure of the inter-relationship between two market prices. Correlation is a number between minus one and one. A positive correlation implies that the two market prices tend to move in the same direction, with a correlation of one implying that they always move in the same direction. A negative correlation implies that the two market prices tend to move in opposite directions, with a correlation of minus one implying that the two market prices always move in opposite directions.

Correlation is used to value more complex instruments where the payout is dependent upon more than one market price. Correlation may be unobservable. Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, the Group's trade prices, proxy correlations and examination of historical price relationships.

The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair. For any single unobservable correlation, the uncertainty in the correlation determination is likely to be less than the range quoted above.

###### 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. 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.

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

### 39 Fair value of financial instruments (continued)

#### (b) Fair value of financial instruments not carried at fair value

The following table provides an analysis of the fair value of financial instruments not measured at fair value on the balance sheet. For all other instruments, the fair value is equal to the carrying value.

	At 30 June 2014		At 30 June 2013		At 31 December 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets</b>						
Placings with and advances to banks	142,975	143,008	141,012	140,968	141,940	141,906
Loans and advances to customers	632,947	629,536	579,705	575,953	586,240	582,893
Held-to-maturity debt securities	70,228	71,753	70,935	72,386	71,505	72,014
<b>Financial Liabilities</b>						
Current, savings and other deposit accounts	860,092	860,239	779,884	779,982	824,996	825,093
Deposits from banks	11,335	11,335	14,165	14,165	11,826	11,826
Certificates of deposit and other debt securities in issue	9,904	10,008	11,022	11,043	8,601	8,601
Subordinated liabilities	11,820	13,687	11,829	13,939	11,824	13,799

The calculation of fair values of financial instruments that are not carried at fair value is described below.

The calculation of fair value incorporates the Group's estimate of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It does not reflect the economic benefits and costs that the Group expects to flow from the instruments' cash flows over their expected future lives.

#### (i) Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. These assumptions may include value estimates from third party brokers which reflect over-the-counter trading activity; forward looking discounted cash flow models using assumptions which the Group believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors, including vintage, origination period, estimates of future interest rates, prepayment speeds, delinquency rates, loan-to-value ratios, the quality of collateral, default probability, and internal credit risk ratings.

Valuation techniques are calibrated on a regular basis and tested for validity using prices from observable current market transactions in the same instrument, without modification or repackaging, or are based on any available observable market data.

The fair value of a loan reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans, and the fair value impact of repricing between origination and the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

#### (ii) Financial investments

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration the prices and future earnings streams of equivalent quoted securities.

#### (iii) Deposits by banks and customer accounts

For the purpose of estimating fair value, deposits by banks and customer accounts are grouped by remaining contractual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

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

### 39 Fair value of financial instruments *(continued)*

#### (b) Fair value of financial instruments not carried at fair value *(continued)*

- (iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the Group as a going concern.

The following table lists financial instruments for which their carrying amounts are reasonable approximations of their fair values because, for example, they are short-term in nature or reprice to current market rates frequently:

#### **Assets**

Cash and balances at central banks  
Items in the course of collection from other banks  
Reverse repurchase agreements – non trading  
Acceptances and Endorsements  
Short-term receivables within "Other assets"  
Accrued income

#### **Liabilities**

Items in the course of transmission to other banks  
Repurchase agreements – non trading  
Acceptances and Endorsements  
Short-term payables within "Other liabilities"  
Accruals

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

### 40 Statutory accounts

The information in this interim report is not audited and does not constitute statutory accounts.

Certain financial information in this interim report is extracted from the statutory accounts for the year ended 31 December 2013, which have been delivered to the Registrar of Companies and the HKMA. The auditors expressed an unqualified opinion on those statutory accounts in their report dated 24 February 2014. The Annual Report and Financial Statements for the year ended 31 December 2013, which includes the statutory accounts, can be obtained on request from the Legal and Company Secretarial Services Department, Level 10, 83 Des Voeux Road Central, Hong Kong; or from Hang Seng Bank's website [www.hangseng.com](http://www.hangseng.com).

### 41 The New Hong Kong Companies Ordinance (Cap. 622)

The New Hong Kong Companies Ordinance ("NCO") (Cap. 622) came into effect on 3 March 2014. On this effective date, the concept of par (nominal) value no longer exist. Consequently, the concepts of "share premium", "capital redemption reserve" and "authorised share capital" are also abolished. Any amount received for issuing equity shares of a company should be recorded as part of "share capital". The effect of the transition is to subsume share premium account and capital redemption reserve balances into share capital as set out in section 37 of Schedule 11 to the NCO (Cap. 622). Prior to 3 March 2014, the application of the share premium account and the capital redemption reserve was governed by sections 48B and 49H respectively of the predecessor Hong Kong Companies Ordinance (Cap. 32).

As at 31 December 2013, 1,911,842,736 ordinary shares of the Bank, with par value of \$5 each, were authorised for issue. Under the NCO (Cap. 622), as part of the transition to the no-par value regime, the amount of HK\$99m standing to the credit of the capital redemption reserve on 3 March 2014 have become part of the Bank's share capital, under the NCO (Cap. 622).

These changes do not have an impact on the number of shares in issue or the relative entitlement of any of the members.

### 42 Changes in presentation

From 1 January 2014, non-trading reverse repurchase agreements and repurchase agreements are presented as separate lines in the balance sheet to align disclosure with market practice and provide more meaningful information in relation to loans and advances. Previously, non-trading reverse repurchase agreements were included within "Placings with and advances to banks" and "Loans and advances to customers" and non-trading repurchase agreements were included within "Deposits from banks" and "Current, savings and other deposit accounts".

The Group has also changed the balance sheet line item, "Cash and balances with banks" to "Cash and balances at central banks". "Balances with banks", is now included within "Placings with and advances to banks".

Comparative figures have been presented accordingly and the affected lines are shown below. There are no other effects of this change in presentation.

	As disclosed	Adjustments	As restated
<b>31 December 2013 consolidated balance sheet items</b>			
<b>Assets</b>			
Cash and balances with banks/ Cash and balances at central banks	33,294	(10,577)	22,717
Placings with and advances to banks	131,363	10,577	141,940
<b>30 June 2013 consolidated balance sheet items</b>			
<b>Assets</b>			
Cash and balances with banks*/ Cash and balances at central banks	14,811	(5,013)	9,798
Placings with and advances to banks	135,999	5,013	141,012
<b>Liabilities</b>			
Repurchase agreements - non trading	-	1,625	1,625
Deposit from banks	15,790	(1,625)	14,165

\* The balance as disclosed under "Cash and balances with banks" at 30 June 2013 was HK\$19,190m. After adjusting the gold bullion balances of HK\$4,379m as set out under note 30 "Other assets", the revised "Cash and balances with banks" was HK\$14,811m.

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

### 43 Comparative figures

Certain comparative figures have been adjusted to conform with the current period's presentation.

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### 44 The appointment of PricewaterhouseCoopers LLP ("PwC") as the Group's auditor

The Board of the Bank announces its intention to ask its shareholders to approve the appointment of PricewaterhouseCoopers LLP ("PwC") as its auditor for the year ending 31 December 2015, upon the expiry of the term of appointment of its incumbent auditor, KPMG, at the Bank's Annual General Meeting in 2015.

The proposed appointment has been reviewed and is recommended by the Bank's Audit Committee and the Board after taking into account the totality of relevant factors.

KPMG (previously known as Peat, Marwick, Mitchell & Co.) has been the auditor of the Group since 1955. Nevertheless, the Bank considers that the appointment of PwC, being an equally professional and qualified audit firm with extensive expertise and experience in the audit of financial institutions, will align the audit arrangements between the Bank and the parent company with a view to enhancing the efficiency and effectiveness of the audit in terms of both cost and audit process. Such appointment will not lead to any adverse cost implication as PwC has offered a competitive fee quotation for undertaking the audit work.

KPMG, the Bank's current auditor, will continue in the role and will undertake the audit of the Group's consolidated accounts for the year ending 31 December 2014, having been reappointed at the 2014 Annual General Meeting, in order to facilitate a smooth transition. Following finalisation of the terms of the engagement of PwC, the appointment of PwC will be recommended to shareholders for approval at the 2015 Annual General Meeting.

The Board looks forward to a constructive and professional relationship with PwC in support of the Audit Committee's responsibility for oversight over the integrity of financial reporting.

There are no matters in connection with KPMG's prospective retirement as auditors which, in the view of the Board, need to be brought to the attention of shareholders.

In accordance with the statutory and regulatory requirements in Hong Kong, the Board will receive from KPMG, upon their retirement as auditor, notification of any circumstances which need to be brought to the attention of either the creditors or shareholders of the Bank.

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### 45 Accounting treatment for Industrial Bank Co., Ltd. ("Industrial Bank") and Yantai Bank Co., Ltd. ("Yantai Bank")

#### Industrial Bank

The Group recorded an accounting gain of HK\$9,517m (The accounting gain included the deemed disposal profit on the reclassification of HK\$8,454m and the release of deferred tax of HK\$1,063m) on the reclassification of Industrial Bank as a financial investment following its issue of additional share capital to third parties in the first half of 2013.

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

### 45 Accounting treatment for Industrial Bank Co., Ltd. ("Industrial Bank") and Yantai Bank Co., Ltd. ("Yantai Bank") (continued)

#### Industrial Bank (continued)

Since there are significant financial implications as a result of the change in accounting treatment for Industrial Bank, the key financial results and performance metrics are not directly comparable when comparing the first half 2014 with the same period last year. For the sake of comparison, we have prepared the following key financial results and performance metrics by excluding the accounting gain in the first half of 2013.

	As Reported			Excluding Industrial Bank reclassification		
	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Change *	Half-year ended 30 June 2014	Half-year ended 30 June 2013	Change *
Attributable profit	<b>8,468</b>	18,468	-54.1%	<b>8,468</b>	8,951	-5.4%
Profit before tax	<b>9,877</b>	18,773	-47.4%	<b>9,877</b>	10,319	-4.3%
Return on average shareholders' funds (%)	<b>15.9</b>	35.9	-20.0pp	<b>16.6</b>	19.0	-2.4pp
Return on average total assets (%)	<b>1.5</b>	3.4	-1.9pp	<b>1.5</b>	1.7	-0.2pp
Earnings per share (HK\$)	<b>4.43</b>	9.66	-54.1%	<b>4.43</b>	4.68	-5.3%

\*Change in "pp" represents change in percentage points.

#### Yantai Bank

The Group recorded an accounting loss of HK\$297m on the reclassification of Yantai Bank as a financial investment following an increase in its registered share capital to enable a private placement of additional share capital to a third party in the second half of 2013. Since then, the fair value of the Bank's investment in Yantai Bank had been below the carrying amount at 30 June 2014. The Group will continue to perform an impairment review of its investment in Yantai Bank at each balance sheet date in accordance with the Group's accounting policy on impairment of available-for-sale financial assets and, if appropriate, would recognise an impairment charge.

### 46 Property revaluation

The Group's premises and investment properties were revalued at 30 June 2014 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of property was market value which is consistent with the definition of fair value under HKFRS 13 "Fair Value Measurement" and takes into account the highest and best use of the property from the perspective of market participants. The highest and best use takes into account the use of the property that is physically possible, legally permissible and financially feasible as described in HKFRS 13. The net revaluation surplus for Group premises amounted to HK\$612m was credited to the premises revaluation reserve. The related deferred tax provisions for Group premises was HK\$103m. Revaluation gains of HK\$230m on investment properties (excluding the revaluation gain on properties backing insurance contracts) were recognised through the income statement.

The revaluation exercise also covered business premises and investment properties reclassified as properties held for sale. There was no revaluation gain recognised through the income statement during the period.

### 47 Immediate and ultimate holding companies

The immediate and ultimate holding companies of the Bank are The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong) and HSBC Holdings plc (incorporated in England) respectively.

**Review report**  
**To the Board of Directors of Hang Seng Bank Limited**  
*(Incorporated in Hong Kong with limited liability)*

**Introduction**

We have reviewed the interim financial report set out on pages 46 to 93 which comprises the consolidated balance sheet of Hang Seng Bank Limited (“the Bank”) as of 30 June 2014 and the related consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the six month period then ended and explanatory notes. The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited require the preparation of an interim financial report to be in compliance with the relevant provisions thereof and Hong Kong Accounting Standard 34 “Interim financial reporting” issued by the Hong Kong Institute of Certified Public Accountants. The directors are responsible for the preparation and presentation of the interim financial report in accordance with Hong Kong Accounting Standard 34.

Our responsibility is to form a conclusion, based on our review, on the interim financial report and to report our conclusion solely to you, as a body, in accordance with our agreed terms of engagement, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

**Scope of review**

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, “Review of interim financial information performed by the independent auditor of the entity” issued by the Hong Kong Institute of Certified Public Accountants. A review of the interim financial report consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly we do not express an audit opinion.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the interim financial report as at 30 June 2014 is not prepared, in all material respects, in accordance with Hong Kong Accounting Standard 34 “Interim financial reporting”.

**KPMG**  
Certified Public Accountants  
8<sup>th</sup> Floor, Prince’s Building  
10 Chater Road  
Central, Hong Kong

4 August 2014



## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS *(unaudited)*

These notes set out on pages 95 to 97 are supplementary to and should be read in conjunction with the consolidated financial statements set out on pages 46 to 93. The consolidated financial statements and these supplementary notes taken together comply with the Banking (Disclosure) Rules ("Disclosure Rules") made under section 60A of the Banking Ordinance, as amended by the Banking (Disclosure) (Amendment) Rules 2013 which came into operation on 30 June 2013.

### 1 Basis of preparation

- (a) Except where indicated otherwise, the financial information contained in these supplementary notes has been prepared on a consolidated basis in accordance with Hong Kong Financial Reporting Standards.
- (b) The accounting policies applied in preparing these supplementary notes are the same as those applied in preparing the consolidated financial statements for the period ended 30 June 2014 as set out in note 2 to the financial statements.

### 2 Disclosure for selected exposures

#### Involvement with Special Purpose Entities ("SPEs")

From time to time, the Group enters into certain transactions with customers in the ordinary course of business which involve the establishment of SPEs. The use of SPEs is not a significant part of the Group's activities and the Group is not reliant on SPEs for any material part of its business operations or profitability.

### 3 Analysis of gross loans and advances to customers by categories based on internal classification used by the Group

Gross advances, impaired advances, individually assessed and collectively assessed loan impairment allowances, the amount of new impairment allowances charged to income statement, and the amount of impaired loans and advances written off during the periods in respect of industry sectors which constitute not less than 10 per cent of gross advances to customers are analysed as follows:

	Gross advances	Overdue advances	Impaired advances	Individually assessed loan impairment allowances	Collectively assessed loan impairment allowances	New impairment allowances	Advances written off during the period
<b>At 30 June 2014</b>							
Residential mortgages	164,511	31	96	(7)	-	3	6
Commercial, industrial and international trade	163,927	711	865	(696)	(526)	213	63
Commercial real estate	81,452	23	53	-	(3)	-	-
Other property-related lending	114,577	1	1	(1)	(14)	1	1
<b>At 30 June 2013</b>							
Residential mortgages	156,616	45	120	(5)	(3)	3	-
Commercial, industrial and international trade	165,426	657	910	(643)	(485)	76	18
Commercial real estate	77,678	26	-	-	(4)	-	-
Other property-related lending	84,203	20	42	(2)	(13)	-	-
<b>At 31 December 2013</b>							
Residential mortgages	159,094	54	119	(7)	-	9	-
Commercial, industrial and international trade	155,392	620	931	(691)	(533)	341	69
Commercial real estate	79,670	26	1	-	(3)	-	-
Other property-related lending	93,664	-	47	(1)	(13)	3	1

# SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

## 4 Non-bank Mainland exposures

The analysis of non-bank Mainland exposures is based on the categories of non-bank counterparties and the type of direct exposures defined by the Hong Kong Monetary Authority ("HKMA") under the Disclosure Rules with reference to the HKMA return for non-bank Mainland exposures, which include the Mainland exposures extended by the Bank and its overseas branches and overseas subsidiaries only.

	On-balance sheet exposure	Off-balance sheet exposure	Total exposures	Individually assessed allowances
<b>At 30 June 2014</b>				
Mainland entities	62,680	7,973	70,653	-
Companies and individuals outside Mainland where the credit is granted for use in Mainland	35,707	3,662	39,369	35
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	115	-	115	-
	<u>98,502</u>	<u>11,635</u>	<u>110,137</u>	<u>35</u>
Exposures incurred by the Bank's mainland subsidiary	83,865	9,726	93,591	218
	<u>182,367</u>	<u>21,361</u>	<u>203,728</u>	<u>253</u>

### At 30 June 2013

Mainland entities	39,265	9,105	48,370	-
Companies and individuals outside Mainland where the credit is granted for use in Mainland	25,608	2,673	28,281	45
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	155	-	155	-
	<u>65,028</u>	<u>11,778</u>	<u>76,806</u>	<u>45</u>
Exposures incurred by the Bank's mainland subsidiary	55,619	10,987	66,606	171
	<u>120,647</u>	<u>22,765</u>	<u>143,412</u>	<u>216</u>

### At 31 December 2013

Mainland entities	53,711	8,672	62,383	-
Companies and individuals outside Mainland where the credit is granted for use in Mainland	29,968	4,442	34,410	39
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	153	-	153	-
	<u>83,832</u>	<u>13,114</u>	<u>96,946</u>	<u>39</u>
Exposures incurred by the Bank's mainland subsidiary	73,396	10,747	84,143	175
	<u>157,228</u>	<u>23,861</u>	<u>181,089</u>	<u>214</u>

# SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited) (continued)

## 5 Cross-border claims

Cross-border claims include receivables and loans and advances, and balances due from banks and holdings of certificates of deposit, bills, promissory notes, commercial paper and other negotiable debt instruments, as well as accrued interest and overdue interest on these assets. Claims are classified according to the location of the counterparties after taking into account the transfer of risk. For a claim guaranteed by a party situated in a country different from the counterparty, the risk will be transferred to the country of the guarantor. For a claim on the branch of a bank, the risk will be transferred to the country where its head office is situated. Claims on individual countries or areas, after risk transfer, amounting to 10 per cent or more of the aggregate cross-border claims are shown as follows:

	<b>Banks &amp; other financial institutions</b>	<b>Public sector entities</b>	<b>Sovereign &amp; other</b>	<b>Total</b>
<b>At 30 June 2014</b>				
Asia-Pacific excluding Hong Kong:				
- China	80,920	-	62,585	143,505
- Japan	16,467	-	18,147	34,614
- Other	38,702	2,884	20,953	62,539
	136,089	2,884	101,685	240,658
The Americas:				
- United States	1,668	-	9,468	11,136
- Other	3,693	1,737	15,649	21,079
	5,361	1,737	25,117	32,215
Europe:				
- United Kingdom	6,395	-	3,101	9,496
- Other	13,880	8,093	8,774	30,747
	20,275	8,093	11,875	40,243
<b>At 30 June 2013</b>				
Asia-Pacific excluding Hong Kong:				
- China	86,390	-	50,871	137,261
- Japan	12,873	-	8,402	21,275
- Other	42,924	2,701	17,150	62,775
	142,187	2,701	76,423	221,311
The Americas:				
- United States	3,482	-	5,771	9,253
- Other	5,672	1,511	15,568	22,751
	9,154	1,511	21,339	32,004
Europe:				
- United Kingdom	7,987	-	2,853	10,840
- Other	19,216	6,928	8,932	35,076
	27,203	6,928	11,785	45,916
<b>At 31 December 2013</b>				
Asia-Pacific excluding Hong Kong:				
- China	84,678	-	58,957	143,635
- Japan	12,876	-	25,847	38,723
- Other	42,749	2,838	19,808	65,395
	140,303	2,838	104,612	247,753
The Americas:				
- United States	4,036	-	7,468	11,504
- Other	3,563	1,514	17,047	22,124
	7,599	1,514	24,515	33,628
Europe:				
- United Kingdom	7,150	-	2,834	9,984
- Other	12,731	7,394	9,269	29,394
	19,881	7,394	12,103	39,378

## **ADDITIONAL INFORMATION**

### **The Code for Securities Transactions by Directors**

The Bank has adopted a Code for Securities Transactions by Directors on terms no less exacting than the required standards as set out in the Model Code for Securities Transactions by Directors of Listed Issuers (as set out in Appendix 10 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (“Listing Rules”). Specific enquiries have been made with all Directors (including the one who has ceased to be a Director during the first six months of 2014) who have confirmed that they have complied with the Bank’s Code for Securities Transactions by Directors throughout the six months ended 30 June 2014.

### **Changes in Directors’ Details**

Changes in Directors’ details since the date of the Annual Report 2013 of the Bank which are required to be disclosed pursuant to Rule 13.51(2) and Rule 13.51B(1) of the Listing Rules, are set out below.

#### **Dr Raymond CH’IEN Kuo Fung GBS, CBE, JP**

##### Cessation of appointment

- Convenience Retail Asia Limited<sup>(1)</sup> (Independent Non-executive Director)

#### **Ms Rose LEE Wai Mun**

##### New appointments

- The Community Chest of Hong Kong (Chairman of the Campaign Committee)
- The Community Chest of Hong Kong (Second Vice President)
- The Community Chest of Hong Kong (Member of Executive Committee)
- Inaugural Financial Consulting Committee for Authority of Qianhai Shenzhen - Hong Kong Modern Service Industry Cooperation Zone of Shenzhen (Member)

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

##### New appointments

- The Community Chest of Hong Kong (Chairman of Public Relations Committee)
- The Community Chest of Hong Kong (Third Vice President)
- The Community Chest of Hong Kong (Member of Executive Committee)

#### **Ms CHIANG Lai Yuen JP**

##### Cessation of appointment

- Directorate Salaries and Conditions of Service of HKSAR Government (Member of Standing Committee)

#### **Ms Irene LEE Yun Lien**

##### New appointments

- Hang Seng Bank Limited<sup>(1)</sup> (Chairman of Risk Committee)
- Hang Seng Bank Limited<sup>(1)</sup> (Member of Audit Committee)

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

##### New appointments

- Airport Authority Hong Kong (Chairman)
- Lantau Development Advisory Committee of HKSAR Government (Non-official Member)

**Mr Kenneth NG Sing Yip**

New appointment

- Competition Tribunal Users' Committee of HKSAR Government (Member)

Cessation of appointment

- Board of Review of Inland Revenue Ordinance of HKSAR Government (Member)

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

Cessation of appointment

- Steering Committee of HKSAR Government Scholarship Fund (Member)

**Mr Peter WONG Tung Shun JP**

New appointment

- The Community Chest of Hong Kong (Board Member)

**Mr Michael WU Wei Kuo**

New appointment

- Hang Seng Bank Limited<sup>(1)</sup> (Member of Audit Committee)

Notes:

- (1) The securities of these companies are listed on a securities market in Kong Kong.
- (2) Updated biographical details of the Bank's Directors are also available on the website of the Bank.

Other than those disclosed above, there is no other information required to be disclosed pursuant to Rule 13.51B(1) of the Listing Rules.

## Directors' and Alternate Chief Executives' Interests

As at 30 June 2014, the interests of the Directors and Alternate Chief Executives in the shares, underlying shares of equity derivatives and debentures of the Bank and its associated corporations (all within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) disclosed in accordance with the Listing Rules were detailed below.

### Interests in shares

	Personal Interests (held as beneficial owner)	Family Interests (interests of spouse or child under 18)	Corporate Interests (interests of controlled corporation)	Other Interests	Total Interests	Total Interests as % of the relevant shares in issue/ issued share capital
<b>Number of ordinary shares in the Bank</b>						
<u>Director:</u>						
Dr John C C Chan	1,000 <sup>(1)</sup>	-	-	-	1,000	0.00
<b>Number of ordinary shares of US\$0.50 each in HSBC Holdings plc</b>						
<u>Directors:</u>						
Dr Raymond K F Ch'ien	57,814	-	-	-	57,814	0.00
Ms Rose W M Lee	197,714	1,485	-	97,462 <sup>(3)</sup>	296,661	0.00
Dr John C C Chan	24,605 <sup>(1)</sup>	-	-	-	24,605	0.00
Mr Nixon L S Chan	50,940	-	-	23,663 <sup>(3)</sup>	74,603	0.00
Mr Andrew H C Fung	75,297	-	-	36,565 <sup>(3)</sup>	111,862	0.00
Ms Sarah C Legg	132,745	2,688	-	73,880 <sup>(3)</sup>	209,313	0.00
Dr Eric K C Li	-	46,293	-	-	46,293	0.00
Mr Kenneth S Y Ng	311,772	-	-	48,155 <sup>(3)</sup>	359,927	0.00
Mr Peter T S Wong	964,958	19,609	-	1,060,138 <sup>(3)</sup>	2,044,705	0.01
<u>Alternate Chief Executives:</u>						
Mr Christopher H N Ho	104,717	49,992	-	6,268 <sup>(3)</sup>	160,977	0.00
Mr Donald Y S Lam	37,791	-	-	14,100 <sup>(3)</sup>	51,891	0.00
Mr Andrew W L Leung	8,369	-	-	6,569 <sup>(3)</sup>	14,938	0.00
<b>Number of perpetual non- cumulative preference shares of US\$0.01 each in HSBC Holdings plc</b>						
<u>Director:</u>						
Ms Rose W M Lee	-	-	-	306,075 <sup>(2)</sup>	306,075	0.20

Interests in debentures of associated corporation of the Bank

Name of debenture	Name of Director	Personal Interests (held as beneficial owner)	Family Interests (interests of spouse or child under 18)	Corporate Interests (interests of controlled corporation)	Other Interests	Total Interests
8.00% perpetual subordinated capital securities, series 2 issued by HSBC Holdings plc	Ms Rose W M Lee	-	-	-	US\$7,651,875 <sup>(2)</sup>	US\$7,651,875

Notes:

- (1) 1,000 shares in the Bank and 4,371 shares in HSBC Holdings plc were jointly held by Dr John C Chan and his wife.
- (2) Ms Rose W M Lee was a beneficiary of a trust, which had interests in the total principal amount of US\$7,651,875 of the 8.00% perpetual subordinated capital securities, series 2. These perpetual subordinated capital securities were exchangeable at the option of HSBC Holdings plc to 306,075 perpetual non-cumulative preference shares of US\$0.01 each in HSBC Holdings plc. Ms Lee's interests set out in the table under "Interests in shares" and the table under "Interests in debentures of associated corporation of the Bank" represented the same interests.
- (3) These represented interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans to acquire ordinary shares of US\$0.50 each in HSBC Holdings plc and (ii) conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc under the HSBC Share Plans made in favour of Directors and Alternate Chief Executives, as set against their respective names below:

	Options (please refer to the options table below for details)	Conditional awards of shares under the HSBC Share Plans (please refer to the awards table below for details)	Total
<u>Directors:</u>			
Ms Rose W M Lee	-	97,462	97,462
Mr Nixon L S Chan	-	23,663	23,663
Mr Andrew H C Fung	4,197	32,368	36,565
Ms Sarah C Legg	4,529	69,351	73,880
Mr Kenneth S Y Ng	-	48,155	48,155
Mr Peter T S Wong	-	1,060,138	1,060,138
<u>Alternate Chief Executives:</u>			
Mr Christopher H N Ho	-	6,268	6,268
Mr Donald Y S Lam	4,197	9,903	14,100
Mr Andrew W L Leung	-	6,569	6,569

### Options

As at 30 June 2014, the Directors and Alternate Chief Executives mentioned below held unlisted physically settled options to acquire the number of ordinary shares of US\$0.50 each in HSBC Holdings plc set against their respective names. These options were granted for nil consideration by HSBC Holdings plc.

	Options held as at 30 June 2014	Options cancelled during the Director's/ Alternate Chief Executive's term of office in the first half of the year	Exercise price per share	Date granted	Exercisable from	Exercisable until
<u>Directors:</u>						
Mr Nixon L S Chan	-	4,533	£7.2181	30 Apr 2004	30 Apr 2009	29 Apr 2014
Mr Andrew H C Fung	4,197	-	HK\$37.8797	29 Apr 2009	1 Aug 2014	31 Jan 2015
Ms Sarah C Legg	- 4,529 4,529	5,738 -	£7.2181 £3.3116	30 Apr 2004 29 Apr 2009	30 Apr 2009 1 Aug 2014	30 Apr 2014 31 Jan 2015
<u>Alternate Chief Executives:</u>						
Mr Christopher H N Ho	-	3,443	£7.2181	30 Apr 2004	30 Apr 2009	29 Apr 2014
Mr Donald Y S Lam	- 4,197 4,197	6,885 -	£7.2181 HK\$37.8797	30 Apr 2004 29 Apr 2009	30 Apr 2009 1 Aug 2014	30 Apr 2014 31 Jan 2015



### Conditional Awards of Shares

As at 30 June 2014, the interests of the Directors and Alternate Chief Executives in the conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc made in favour of them under the HSBC Share Plans were as follows:

	Awards made during the Director's/ Alternate Chief Executive's term of office in the first half of the year	Awards released during the Director's/ Alternate Chief Executive's term of office in the first half of the year	Awards held as at 30 June 2014	
Awards held as at 1 January 2014				
<u>Directors:</u>				
Ms Rose W M Lee	35,062	98,372	37,802	97,462 <sup>(1)</sup>
Mr Nixon L S Chan	17,625	13,618	8,058	23,663 <sup>(1)</sup>
Mr Andrew H C Fung	29,668	17,405	15,409	32,368 <sup>(1)</sup>
Ms Sarah C Legg	66,132	52,215	50,384	69,351 <sup>(1)</sup>
Mr Kenneth S Y Ng	73,593 <sup>(2)</sup>	-	26,505	48,155 <sup>(1)</sup>
Mr Peter T S Wong	765,649	398,720	124,750	1,060,138 <sup>(1)</sup>
<u>Alternate Chief Executives:</u>				
Mr Christopher H N Ho	3,913	4,227	2,001	6,268 <sup>(1)</sup>
Mr Donald Y S Lam	8,608	4,973	3,877	9,903 <sup>(1)</sup>
Mr Andrew W L Leung	3,545	4,565	1,672	6,569 <sup>(1)</sup>

Notes:

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

(2) This represents the awards held by Mr Kenneth S Y Ng on 10 March 2014 when he was appointed a Director of the Bank.

All the interests stated above represent long positions. As at 30 June 2014, no short positions were recorded in the Register of Directors' and Alternate Chief Executives' Interests and Short Positions required to be kept under section 352 of the SFO.

Other than those disclosed above, no right to subscribe for equity or debt securities of the Bank has been granted by the Bank to, nor have any such rights been exercised by, any person during the six months ended 30 June 2014.

### Substantial Interests in Share Capital

The register maintained by the Bank pursuant to the SFO recorded that, as at 30 June 2014, the following corporations had interests or short positions in the shares or underlying shares (as defined in the SFO) in the Bank set opposite their respective names:

Name of Corporation	Number of Ordinary Shares in the Bank (Percentage of total)
The Hongkong and Shanghai Banking Corporation Limited	1,188,057,371 (62.14%)
HSBC Asia Holdings BV	1,188,057,371 (62.14%)
HSBC Asia Holdings (UK) Limited	1,188,057,371 (62.14%)
HSBC Holdings BV	1,188,057,371 (62.14%)
HSBC Finance (Netherlands)	1,188,057,371 (62.14%)
HSBC Holdings plc	1,188,057,371 (62.14%)

The Hongkong and Shanghai Banking Corporation Limited is a wholly-owned subsidiary of HSBC Asia Holdings BV, which is a wholly-owned subsidiary of HSBC Asia Holdings (UK) Limited, which in turn is a wholly-owned subsidiary of HSBC Holdings BV. HSBC Holdings BV is a wholly-owned subsidiary of HSBC Finance (Netherlands), which in turn is a wholly-owned subsidiary of HSBC Holdings plc. Accordingly, The Hongkong and Shanghai Banking Corporation Limited's interests are recorded as the interests of HSBC Asia Holdings BV, HSBC Asia Holdings (UK) Limited, HSBC Holdings BV, HSBC Finance (Netherlands) and HSBC Holdings plc.

The Directors regard HSBC Holdings plc to be the beneficial owner of 1,188,057,371 ordinary shares in the Bank (62.14%).

All the interests stated above represent long positions. As at 30 June 2014, no short positions were recorded in the Register of Interests in Shares and Short Positions required to be kept under section 336 of the SFO.

### Purchase, Sale or Redemption of the Bank's Listed Securities

There was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's listed securities during the first half of 2014.

### Remuneration and Staff Development

There have been no material changes to the information disclosed in the Annual Report 2013 in respect of the remuneration of employees, remuneration policies and staff development.

## **Code on Corporate Governance Practices**

The Bank is committed to high standards of corporate governance with a view to safeguarding the interests of shareholders, customers, staff and other stakeholders. The Bank has followed the module on ‘Corporate Governance of Locally Incorporated Authorised Institutions’ under the Supervisory Policy Manual (“SPM”) issued by the Hong Kong Monetary Authority (“HKMA”) and has fully complied with all the code provisions and most of the recommended best practices as set out in the Corporate Governance Code contained in Appendix 14 of the Listing Rules throughout the six months ended 30 June 2014, save that the Risk Committee (all the members of which are Independent Non-executive Directors), which was established pursuant to HKMA’s SPM on corporate governance, is responsible for the oversight of internal control (other than internal control over financial reporting) and risk management systems. If there were no Risk Committee, these matters would be the responsibility of the Audit Committee, as provided under the aforesaid Corporate Governance Code.

The Audit Committee of the Bank has reviewed the results of the Bank for the six months ended 30 June 2014.

## **Register of Shareholders**

The Register of Shareholders of the Bank will be closed on Wednesday, 20 August 2014, during which no transfer of shares can be registered. To qualify for the second interim dividend, all transfers, accompanied by the relevant share certificates, must be lodged with the Bank’s Registrar, Computershare Hong Kong Investor Services Limited, at Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen’s Road East, Wanchai, Hong Kong, for registration not later than 4:30 pm on Tuesday, 19 August 2014. The second interim dividend will be payable on Thursday, 4 September 2014 to shareholders on the Register of Shareholders of the Bank on Wednesday, 20 August 2014. Shares of the Bank will be traded ex-dividend as from Monday, 18 August 2014.

## **Proposed Timetables for the Remaining Quarterly Dividends for 2014**

### *Third interim dividend for 2014*

Announcement date	6 October 2014
Book close and record date	22 October 2014
Payment date	6 November 2014

### *Fourth interim dividend for 2014*

Announcement date	23 February 2015
Book close and record date	11 March 2015
Payment date	26 March 2015

## **Board and Committees**

### **Board**

#### Independent Non-executive Chairman

Raymond CH' IEN Kuo Fung

#### Executive Directors

Rose LEE Wai Mun (Vice-Chairman and Chief Executive)

Andrew FUNG Hau Chung

Nixon CHAN Lik Sang

#### Non-executive Directors

Sarah Catherine LEGG

Vincent LO Hong Sui

Kenneth NG Sing Yip<sup>(1)</sup>

Peter WONG Tung Shun

#### Independent Non-executive Directors

John CHAN Cho Chak

Henry CHENG Kar Shun<sup>(2)</sup>

CHIANG Lai Yuen

HU Zulu, Fred

Irene LEE Yun Lien<sup>(3)</sup>

Eric LI Ka Cheung

Richard TANG Yat Sun

Michael WU Wei Kuo

### **Committees**

#### Executive Committee

Rose LEE Wai Mun (Chairman)

Andrew FUNG Hau Chung

Nixon CHAN Lik Sang

Christopher HO Hing Nin

Donald LAM Yin Shing

Andrew LEUNG Wing Lok

Louise LAM

Ivy CHAN Shuk Pui

#### Audit Committee

Eric LI Ka Cheung (Chairman)

Irene LEE Yun Lien

Richard TANG Yat Sun

Michael WU Wei Kuo

#### Remuneration Committee

John CHAN Cho Chak (Chairman)

Raymond CH' IEN Kuo Fung

CHIANG Lai Yuen

#### Risk Committee

Irene LEE Yun Lien (Chairman)

HU Zulu, Fred

Eric LI Ka Cheung

Nomination Committee

Raymond CH' IEN Kuo Fung (Chairman)

Rose LEE Wai Mun

John CHAN Cho Chak

Peter WONG Tung Shun

Michael WU Wei Kuo

Notes:

- (1) Mr Kenneth S Y Ng was appointed a Non-executive Director of the Bank with effect from 10 March 2014.
- (2) Dr Henry K S Cheng was appointed an Independent Non-executive Director of the Bank with effect from 26 May 2014.
- (3) Ms Irene Y L Lee was appointed an Independent Non-executive Director of the Bank with effect from 12 May 2014.
- (4) Dr Marvin K T Cheung resigned as Independent Non-executive Director of the Bank with effect from 1 August 2014.
- (5) Terms of Reference of the Bank's Audit Committee, Remuneration Committee, Risk Committee and Nomination Committee are available on the websites of the Bank and Hong Kong Exchanges and Clearing Limited ("HKEx").
- (6) List of Directors identifying their role and function is available on the websites of the Bank and HKEx.

**Registered Office**

83 Des Voeux Road Central, Hong Kong

Website: [www.hangseng.com](http://www.hangseng.com)

Email: [hangseng@computershare.com.hk](mailto:hangseng@computershare.com.hk)

**Stock Code**

The Stock Exchange of Hong Kong Limited: 11

**Registrar**

Computershare Hong Kong Investor Services Limited

Shops 1712-1716, 17th Floor, Hopewell Centre

183 Queen's Road East, Wanchai, Hong Kong

**Depository\***

BNY Mellon Shareowner Services

PO Box 30170

College Station, TX 77842-3170, USA

Telephone: 1-201-680-6825

Toll free (domestic): 1-888-BNY-ADRS

Website: [www.mybnymdr.com](http://www.mybnymdr.com)

Email: [shrrelations@cpushareownerservices.com](mailto:shrrelations@cpushareownerservices.com)

\* The Bank offers investors in the United States a Sponsored Level-1 American Depositary Receipts Programme through The Bank of New York Mellon Corporation.

**Interim Report 2014**

This Interim Report 2014 in both English and Chinese is now available in printed form and on the Bank's website ([www.hangseng.com](http://www.hangseng.com)) and the website of HKEx ([www.hkexnews.hk](http://www.hkexnews.hk)).

Shareholders who:

- A) browse this Interim Report 2014 on the Bank's website and wish to receive a printed copy; or
- B) receive this Interim Report 2014 in either English or Chinese and wish to receive a printed copy in the other language version,

may send a request form, which can be obtained from the Bank's Registrar or downloaded from the Bank's website ([www.hangseng.com](http://www.hangseng.com)) or HKEx's website ([www.hkexnews.hk](http://www.hkexnews.hk)), to the Bank's Registrar:

Computershare Hong Kong Investor Services Limited

17M Floor, Hopewell Centre

183 Queen's Road East

Wanchai, Hong Kong

Facsimile: (852) 2529 6087

Email: [hangseng@computershare.com.hk](mailto:hangseng@computershare.com.hk)

If shareholders who have chosen (or deemed to have chosen) to read this Interim Report 2014 on the Bank's website have difficulty in reading or gaining access to this Interim Report 2014 via the Bank's website for any reason, the Bank will promptly send this Interim Report 2014 in printed form free of charge upon the shareholders' request.

Shareholders may change their choice of means of receipt or language of the Bank's future corporate communications at any time, free of charge, by giving the Bank c/o the Bank's Registrar reasonable notice in writing or by email to [hangseng@computershare.com.hk](mailto:hangseng@computershare.com.hk).