

2005

**The Hongkong and Shanghai
Banking Corporation Limited**

*Annual Report
and Accounts*

The world's local bank



Annual Report and Accounts 2005

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A Chinese translation of the *Annual Report and Accounts* is available upon request from: Group Public Affairs, Level 32, HSBC Main Building, 1 Queen's Road Central, Hong Kong. The report is also available, in English and Chinese, on the Bank's web site at www.asiapacific.hsbc.com.

本年報及結算表備有中譯本，如欲查閱可向下列地址索取：香港皇后大道中1號滙豐總行大廈32樓集團公共事務部。本年報之中英文本亦載於本行之網址 www.asiapacific.hsbc.com。

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Within this document the Hong Kong Special Administrative Region of the People's Republic of China is referred to as 'Hong Kong'.

Financial Highlights: The Hongkong and Shanghai Banking Corporation Limited and Subsidiaries

	2005	2004
For the year	HK\$m	HK\$m
Net operating income before loan impairment charges	77,222	69,286
Profit before tax	45,249	43,536
Profit attributable to shareholders	32,873	32,148
At year-end		
Shareholders' funds	97,334	83,807
Total equity	114,425	100,117
Total regulatory capital	154,065	139,456
Customer accounts	1,735,110	1,728,111
Total assets	2,672,532	2,486,815
Risk-weighted assets	1,238,164	1,173,432
Ratios	%	%
Return on average shareholders' funds	37.4	43.1
Post-tax return on average total assets	1.44	1.57
Cost efficiency ratio	41.2	38.8
Net interest margin	2.14	1.92
Capital adequacy ratios		
– total capital	12.4	11.9
– tier 1 capital	11.7	11.4

Comparative figures have been restated to reflect the adoption of a number of new and revised Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards.

Established in Hong Kong in March 1865 and in Shanghai one month later, The Hongkong and Shanghai Banking Corporation Limited is the founding member of the HSBC Group – one of the world's largest banking and financial services organisations – and its flagship in the Asia-Pacific region. It is the largest bank incorporated in the Hong Kong Special Administrative Region and one of the SAR's three note-issuing banks.

Serving the financial and wealth management needs of an international customer base, the Bank and its subsidiaries provide a complete range of personal, commercial and corporate banking and related financial services through over 600 branches and offices in 20 countries and territories in Asia-Pacific and 20 branches and offices in five other countries around the world. Employing some 50,800 people, of whom 34,400 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2005 of HK\$2,673 billion.

The Hongkong and Shanghai Banking Corporation Limited is a wholly owned subsidiary of HSBC Holdings plc, the holding company of the HSBC Group, which has around 9,500 offices in 76 countries and territories and assets of US\$1,502 billion.

The Hongkong and Shanghai Banking Corporation Limited

Incorporated in the Hong Kong SAR with limited liability

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Report of the Directors

Board of Directors

Vincent Cheng Hoi Chuen, GBS, OBE, <i>Chairman</i>	Zia Mody (<i>appointed on 12 January 2006</i>)
Dr William Fung Kwok Lun, OBE, <i>Deputy Chairman</i>	Raymond Or Ching Fai
Michael R P Smith OBE, <i>President and Chief Executive Officer</i>	Christopher D Pratt (<i>appointed on 27 February 2006</i>)
Sir John Bond	Jack So Chak Kwong
Laura Cha May Lung, SBS	T Brian Stevenson, SBS
Dr Raymond Ch'ien Kuo Fung, GBS, CBE	Dr Patrick Wang Shui Chung
Stephen K Green	Peter Wong Tung Shun (<i>appointed on 1 April 2005</i>)
Victor Li Tzar Kuoi	Dr Rosanna Wong Yick-ming, DBE
Dr Lo Ka Shui, GBS	Marjorie Yang Mun Tak

Principal Activities

The Hongkong and Shanghai Banking Corporation Limited (“the Bank”) and its subsidiary and associated companies (“the group”) provide a comprehensive range of domestic and international banking and related financial services, principally in the Asia-Pacific region.

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 21 to 152.

Reserves

Profits attributable to shareholders, before dividends, of HK\$32,873 million have been transferred to reserves. During the year, a surplus of HK\$1,017 million, net of the related deferred taxation effect, arising from professional valuations of premises and investment properties held by the Bank and the group was credited to reserves. Details of the movements in reserves, including appropriations therefrom, are set out in note 36 to the financial statements. The Directors do not recommend the payment of a final dividend.

Share Capital

The capital has been increased during the year by US\$2,130 million (HK\$16,567 million) by the issue of 2,130 million Cumulative Irredeemable Preference Shares of US\$1.00 each. The shares were issued in order to maintain the capital ratio at an appropriate level, to finance the acquisitions of an interest in Ping An Insurance (Group) Company of China Limited and a further interest in Bank of Communications, and to support business growth. In accordance with Hong Kong Accounting Standard 32, Financial Instruments – Disclosure and Presentation, these Preference Shares are presented as liabilities in the consolidated balance sheet and the balance sheet of the Bank. Details of the movements in share capital of the Bank during the year are set out in notes 34 and 35 to the financial statements.

Directors

The names of the Directors serving during the year and up to the date of this report are set out above, apart from Dr H Sohmen and D G Eldon, who retired on 23 May 2005 and 24 May 2005 respectively, and D M Turnbull who resigned from the Board on 12 December 2005. Sir John Bond will retire on 22 May 2006.

Directors' Interests in Contracts

No contracts of significance to which the Bank, its holding companies, its subsidiary companies or any fellow subsidiary company was a party and in which a Director had a material interest subsisted at the end of the year or at any time during the year.

Directors' Rights to Acquire Shares or Debentures

Certain Directors of the Bank have been granted options and conditional awards over HSBC Holdings plc ordinary shares by that company (being the ultimate holding company) pursuant to the HSBC Savings-Related Share Option Plan, the HSBC Restricted Share Plan and The HSBC Share Plan. During the year, Sir John Bond, V H C Cheng, S K Green, M R P Smith and R C F Or acquired shares in HSBC Holdings plc under the terms of the Restricted Share Plan. Sir John Bond, M R P Smith and R C F Or also acquired shares by exercising options.

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

Executive Committee

An Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board, with responsibility for Credit, Asset and Liability management. The members of the Committee are M R P Smith (Chairman of the Committee), Vincent Cheng Hoi Chuen, Sir John Bond, S K Green, Raymond Or Ching Fai, Peter Wong Tung Shun (Directors), S J Glass (Chief Financial Officer), A P Long (Chief Operating Officer), C R Page (Chief Credit Officer), B G Fredrick (Head of International), Margaret Leung Ko May Yee (General Manager, Global Co-Head Commercial Banking), R S Tait (Head of Human Resources), P A Thurston (General Manager Personal Financial Services) and E I Sinyak (Chief Information Officer).

Audit Committee

An Audit Committee, comprising three non-executive Directors of the Bank, meets regularly with the group's senior management and the internal and external auditors to consider and review the group's financial statements, the nature and scope of audit reviews and the effectiveness of the systems of internal control and compliance. The members of the Audit Committee are T B Stevenson (Chairman of the Committee), Dr Lo Ka Shui and Dr Patrick Wang Shui Chung.

Donations

Donations made by the Bank and its subsidiary companies during the year amounted to HK\$55 million.

Hong Kong Monetary Authority Guidelines on Financial Disclosure and Corporate Governance

The Directors are of the view that the Accounts for the year ended 31 December 2005 fully comply with the Hong Kong Monetary Authority Guidelines on Financial Disclosure by, and Corporate Governance of, Locally Incorporated Authorised Institutions.

Auditors

The Accounts have been audited by KPMG. A resolution to reappoint KPMG as auditors of the Bank will be proposed at the forthcoming Annual General Meeting.

On behalf of the Board
V H C Cheng, *Chairman*
Hong Kong, 6 March 2006

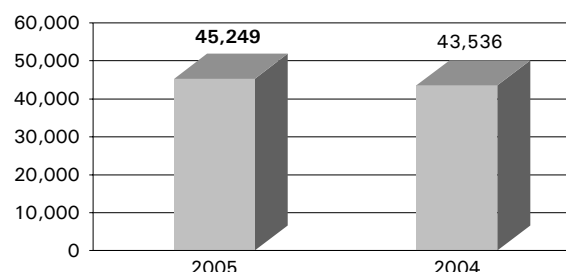
Financial Review

Summary of Financial Performance

Group Profit

Profit attributable to shareholders for 2005 reported by The Hongkong and Shanghai Banking Corporation Limited ('the bank') and its subsidiary and associated companies ('the group') increased by HK\$725 million, or 2.3 per cent, to HK\$32,873 million in 2005. Profit before taxation increased by HK\$1,713 million, or 3.9 per cent, to HK\$45,249 million.

Profit before tax (HK\$ millions)



Economic Profit

The group's internal performance measures include economic profit, a calculation which compares the return on the financial capital invested in the group by its immediate holding company with the cost of that capital. The group prices its cost of capital internally and the difference between that cost and post-tax profit attributable to the ordinary shareholders represents the amount of economic profit generated. Economic profit is used by management as one of the measures to decide where to allocate resources so that they will be most productive. For this purpose, the cost of capital is

currently estimated to be 8.5 per cent in 2005 (2004: 8.0 per cent).

(HK\$ millions)	2005	2004
Average invested capital	138,778	108,197
Return on invested capital*	34,991	32,997
Cost of capital	(11,810)	(8,617)
Economic profit	23,181	24,380

* Return on invested capital represents attributable profit adjusted for non-cash items.

Customer Groups

The group comprises five major customer groups. Personal Financial Services provides financial services to individuals, including self employed individuals (but excluding individuals managed by Private Banking). Commercial Banking manages middle and smaller corporate relationships. Corporate, Investment Banking and Markets includes relationships with large corporate and institutional customers together with the group's treasury, investment banking, private equity and asset management operations. Private Banking provides financial services to high net worth individuals. 'Other' mainly represents certain property activities, centrally held investments and shareholders' funds to the extent that they have not been allocated to the other customer groups.

Personal Financial Services reported profit before tax of HK\$21,640 million, which was HK\$4,313 million, or 24.9 per cent, higher than 2004. There was strong growth in Hong Kong of HK\$4,482 million, or 27.6 per cent, in profit before tax, driven primarily by the widening of deposit spreads following rises in Hong Kong dollar and US dollar interest rates during the year. In the rest of Asia-Pacific, profit before tax fell by 15.9 per cent to HK\$902 million due to higher impairment provisions, while operating profit

excluding loan impairment charges increased by 15.8 per cent, reflecting continued expansion across the region, particularly in mortgages and credit cards, and improved deposit spreads.

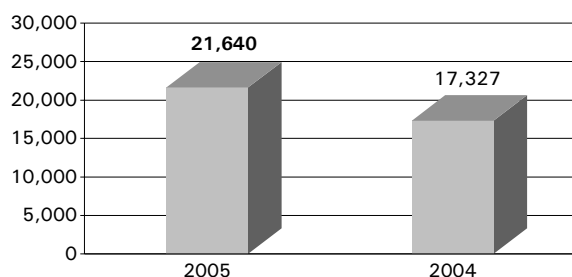
Net interest income increased by HK\$6,016 million, or 28.9 per cent, compared with 2004. In Hong Kong, net interest income improved by HK\$4,656 million, or 29.6 per cent. During 2005, interest rates in Hong Kong rose significantly, reflecting rising US dollar interest rates. In addition, adjustments to the HK\$:US\$ Linked Exchange Rate System reduced the likelihood of an upward realignment of the Hong Kong dollar, prompting a reversal of much of the inward flows from investors that had depressed local market rates in 2004. This led to a widening of deposit spreads to more normal levels compared with the exceptionally low levels experienced in 2004. Competition in the Hong Kong mortgage market remained intense and margins were impacted by the rising cost of funds. In the rest of Asia-Pacific, net interest income rose by HK\$1,362 million, or 26.8 per cent, reflecting strong asset and deposit growth across the region. Mortgage lending increased in Australia, Taiwan, Korea, Singapore and India, benefiting from increased use of a direct sales force and successful promotional

Customer Groups *(continued)*

campaigns, although spreads narrowed in the face of competitive pressures on pricing and higher funding costs. Interest earned on credit cards was higher, notably in Indonesia, the Philippines, India and Taiwan, reflecting strong growth in receivables. The deposit base expanded in a number of countries, particularly mainland China and Singapore, and rising interest rates led to a widening of deposit spreads. Net interest income in 2005 also includes income of HK\$989 million from held-to-maturity investments in the insurance business; such income was included in 'Net investment income on assets backing policyholder liabilities' in 2004.

Personal Financial Services

Profit before tax (HK\$ millions)



Net fee income of HK\$8,050 million was 7.0 per cent higher than in 2004, largely attributable to strong growth in the sales of wealth management and insurance products throughout the rest of Asia-Pacific and higher credit card fee income. Total revenue from wealth management and insurance products for the group grew by HK\$547 million, or 7.0 per cent. Fee income from unit trust sales fell by 21.5 per cent, driven by a change in market sentiment in Hong Kong as, in the higher interest rate environment and with a flattening yield curve, investors reduced their demand for longer-term equity-related investments. Sales of structured deposit products in Hong Kong, however, remained strong as income grew by 69.2 per cent, reflecting increased marketing effort, an enhanced product range and the use of private placement arrangements. Broking and custody income decreased by 6.0 per cent, in line with the fall in retail securities turnover in Hong Kong.

Fee income from credit cards was HK\$435 million, or 20.7 per cent, higher than in 2004, as the group maintained its position as the largest card issuer in Hong Kong, with 4.0 million cards in force. In the rest of Asia-Pacific, cards in issue grew by 32.7 per cent. Innovative and targeted promotional campaigns, together with an enhanced rewards programme, led to increased card spending of HK\$31.3 billion in Hong

Kong and the region, and receivables grew by 30.0 per cent.

The group has continued to grow and develop its insurance business. Overall, insurance income from personal customers rose by 19.3 per cent to HK\$4,522 million. Life assurance income grew, attributable to an enhanced range of insurance and investment products. Revenues from general insurance and the Mandatory Provident Fund business were also higher.

The charge for loan impairment increased, by HK\$54 million to HK\$1,344 million, with higher provisions against credit card lending in the rest of Asia-Pacific, in line with the significant growth in receivables throughout the region, and a sharp rise in provisions in Taiwan reflecting higher delinquency levels. In Hong Kong, however, there were lower provisions in the credit card, mortgage and other personal lending portfolios, as the economy continued to recover with falling unemployment, lower bankruptcies and higher residential property prices.

Operating expenses increased by HK\$1,273 million, or 8.1 per cent, over 2004. Headcount rose to support business expansion across the region and included the recruitment of additional financial planning managers in Hong Kong and sales staff in the rest of Asia-Pacific. Performance-related pay rose in line with the increase in sales revenues. Higher marketing costs were incurred, notably for mortgages, credit cards, insurance and investment products, in order to raise brand awareness and increase market penetration, particularly in the rest of Asia-Pacific. Investment in technology increased to support higher business volumes, new product lines and the continued development of alternative distribution channels. The increase was partly mitigated by the impact of a change in the allocation of certain centrally borne expenses to customer groups.

Income from associates includes a full 12 months' share of profits from Bank of Communications attributable to Personal Financial Services.

Commercial Banking reported profit before tax of HK\$11,131 million, an increase of 26.2 per cent over 2004, attributable primarily to improved deposit spreads, as well as balance sheet growth. Profit before tax in Hong Kong grew by 5.3 per cent to HK\$7,504 million, and in the rest of Asia-Pacific to HK\$3,615 million from HK\$1,681 million. Operating profit excluding loan impairment provisions rose by 40.4 per cent and 22.8 per cent in Hong Kong and the rest of Asia-Pacific respectively.

Financial Review (continued)

Customer Groups (continued)

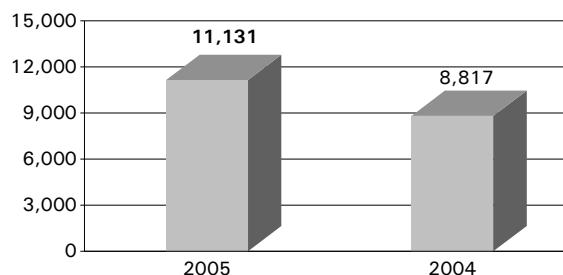
Net interest income increased by HK\$4,024 million, or 57.0 per cent, compared with 2004. This reflected a 10.3 per cent growth in advances since the end of 2004, and improvements in deposit spreads following rises in Hong Kong dollar and US dollar interest rates, coupled with increased active management of the commercial banking deposit base. The benefit was, however, partly offset by competitive pressure on lending margins. In Hong Kong, advances to the property, manufacturing, trading and retail sectors grew, with higher new lending and increased utilisation of existing facilities. The introduction of Core Business Banking Centres in 2004, together with an increase in the number of dedicated relationship managers to serve key accounts, and the implementation of a pre-approved lending programme for small- and medium-sized enterprises, contributed to the growth in lending and deposits. The group continued to benefit from the growth in international trade and the expansion of the Mainland economy. Business links between Hong Kong and mainland China continue to be developed, and three new branches and a sub-branch, with commercial banking presence, were opened. Throughout the region, the sales force and number of relationship managers have increased to take advantage of cross-selling opportunities for insurance and investment products, as well as expanding lending and deposit-taking activities. In the rest of Asia-Pacific, net interest income increased, notably in Singapore, mainland China and Taiwan, as a result of asset and deposit growth and improved deposit spreads. Net interest income also includes income of HK\$694 million from held-to-maturity investments in the insurance business; this was included in 'Net investment income on assets backing policyholder liabilities' in 2004.

Net fee income at HK\$4,524 million was 10.0 per cent higher than 2004. Trade finance activity in Hong Kong and mainland China remained strong, and fee income rose despite increased market competition. The marketing of foreign exchange products such as swaps and options, and of remittance services to Hong Kong customers engaged in international trade was also successful in contributing to revenues. Growth in fees elsewhere in the region was strong, particularly in Indonesia, Bahrain, Vietnam and Thailand, attributable to the expansion of lending and particular focus on developing relationships with customers involved in international trade. Income from the sale of wealth management products fell, reflecting a fall in demand for unit trusts in Hong Kong, partly offset by growth in structured deposits. Income from insurance increased by 6.4 per cent (or 10.7 per cent on an underlying basis, as 2005 includes the allocation of certain commissions to Personal Financial Services) despite intense market

competition, with a new commercial banking insurance division established in Hong Kong to provide customer-focused commercial insurance solutions and services.

Commercial Banking

Profit before tax (HK\$ millions)



There was a swing of HK\$1,534 million in loan impairment provisions to a net charge of HK\$896 million from a net credit of HK\$638 million in 2004, as 2004 benefited from a general provision release. In 2005, there were higher new individual provisions, and lower releases and recoveries, in the bank in Hong Kong and Hang Seng Bank, partly offset by lower new provisions and higher releases in mainland China, and an increase in releases in India.

Operating expenses rose by HK\$640 million, or 13.4 per cent, as the number of relationship managers and support staff increased, although savings were made from initiatives to handle business via low cost channels. This included the enhancement of internet banking for which customer numbers have increased by over 40 per cent. The proportion of commercial banking transactions handled at branch counters fell by more than 10 per cent and now only account for around 65 per cent of all transactions. In mainland China and Korea, costs were driven by increased investment to expand the branch network. A change in the allocation of certain centrally borne expenses to customer groups also contributed to the cost growth.

Income from associates includes a full 12 months' share of profits from Bank of Communications and Industrial Bank attributable to Commercial Banking.

Corporate, Investment Banking and Markets reported profit before tax of HK\$13,252 million, 23.6 per cent lower than 2004, as a result of a decline in net interest income in Global Markets which more than offset a strong trading performance.

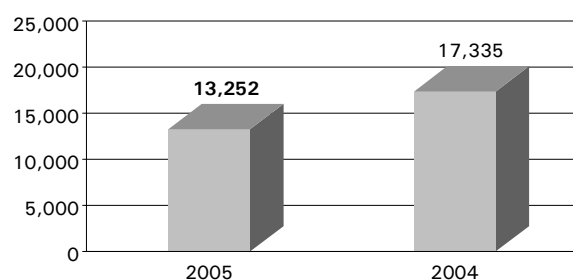
Net interest income fell by HK\$2,533 million, or 22.5 per cent, compared with last year. In Corporate and Institutional Banking, deposit spreads improved following rises in Hong Kong and US dollar interest rates, which together with growth in loans, contributed to an increase in net interest income of 41.4 per cent.

Customer Groups *(continued)*

The payments and cash management business performed exceptionally well, with new mandates won as a result of further enhancements to the product range and the group's cross-border coverage. Liability balances increased following the successful implementation of complex cash management solutions across the region. In addition, India, Taiwan and Korea benefited from the growth in deposits from securities custody and clearing customers. In Global Markets, the adoption of new accounting standards affected trading income through the reclassification of interest and dividend income on trading assets and liabilities from 'Net interest income' and 'Dividend income', to 'Net trading income'. This added HK\$817 million to net interest income but was more than offset by the maturity of higher yielding assets, rising short-term rates and flat yield curves, resulting in less profitable reinvestment opportunities. There was also a reclassification of HK\$199 million from 'Net interest income' to 'Net income from financial instruments at fair value'.

Corporate, Investment Banking and Markets

Profit before tax (HK\$ millions)



Net fee income rose by 7.5 per cent to HK\$5,388 million, principally due to the inclusion of a full year's profits from the Bank of Bermuda businesses, which were integrated into the group at the end of 2004 and contributed HK\$1,219 million to revenues. Corporate and Institutional Banking saw an increase in fees and commissions from the securities custody and clearing business, which benefited from increased stock market activity across the region, notably in Korea and India. The group's expertise in trade services and a well-established network in Asia-Pacific were key factors in securing new business in 2005, resulting in fee growth, particularly in India. Investment banking revenues declined, reflecting a decrease in structured finance transactions, although fee income from the underwriting advisory business rose, with HSBC acting as joint global co-ordinator for three of the five largest initial public offerings ('IPO's) in Hong Kong this year. These were the Hong Kong Government's HK\$22.0 billion Link Real Estate Investment Trust ('REIT')

IPO, the largest ever real estate offering and REIT IPO in the world, the HK\$16.8 billion IPO by Bank of Communications and the HK\$9.5 billion IPO of China COSCO Holdings.

Net trading income increased by HK\$1,420 million, or 24.5 per cent, over 2004, notwithstanding the inclusion of the net interest expense of HK\$817 million on trading assets and liabilities this year. In Hong Kong, investments made in enhancing the structured products platform resulted in increased revenues in foreign exchange options, equity derivatives, structured credit derivatives and interest rate derivatives, but were partly offset by lower revenues generated from capital-guaranteed investment solutions provided to the personal and commercial banking businesses, as retail investors switched to deposit products in the higher interest rate environment. Debt securities trading benefited from correct positioning, with tightening in short-term corporate spreads in the low Hong Kong dollar interest rate environment in the first quarter of 2005. This was, however, partly offset by losses on certain high yield bonds, following the downgrading of certain companies in the automobile sector during the second quarter, as well as a difficult credit trading environment later in the year, reflecting low volatility in credit spreads.

In the rest of Asia-Pacific, excellent progress was made in the roll-out of structured products, particularly in Korea, Singapore and Taiwan. Foreign exchange revenues also improved, notably in Indonesia, benefiting from currency volatility and the group's growing customer franchise in the region.

There was a net release of loan impairment provisions of HK\$165 million, HK\$1,354 million lower than the release in 2004. The credit environment in Hong Kong remained stable, but there were lower releases and recoveries of individual and collective provisions this year.

Operating expenses increased by 32.3 per cent compared with 2004, reflecting higher staff costs and the inclusion of costs relating to the Asia-Pacific operations of Bank of Bermuda. Headcount increased to support business expansion, including the build up of the investment banking division and the recruitment of senior relationship managers to extend coverage along industry sector lines. The cost base was further impacted by a change in the allocation of certain centrally allocated overheads to customer groups and a rise in cost recharges in respect of global management functions.

Financial Review (continued)**Customer Groups** (continued)

Income from associates includes a full 12 months' share of profits from Bank of Communications and Industrial Bank attributable to Corporate, Investment Banking and Markets.

Other includes income and expenses relating to staff housing loans, certain property activities, and investment and other activities that are not allocated to other customer groups.

Net interest income was lower, reflecting an increase in preference shares issued, coupled with higher funding costs. The surplus on property revaluation and profits from property sales were higher, offset by lower gains on the disposal and revaluation of long-term investments.

(HK\$ millions)	Personal Financial Services	Commercial Banking	Corporate, Investment Banking and Markets	Private Banking	Other	Total
2005						
Net interest income	26,801	11,089	8,725	63	(3,187)	43,491
Net fee income	8,050	4,524	5,388	55	80	18,097
Net trading income	683	638	7,215	10	(1,366)	7,180
Net income from financial instruments designated at fair value	666	(648)	122	-	244	384
Gains less losses from financial investments	-	23	19	-	714	756
Dividend income	5	14	167	-	182	368
Net earned insurance premiums	18,437	756	147	-	-	19,340
Other operating income	1,984	295	572	13	2,033	4,897
Total operating income	56,626	16,691	22,355	141	(1,300)	94,513
Net insurance claims incurred and movement in policyholder liabilities	(16,889)	(330)	(72)	-	-	(17,291)
Net operating income before loan impairment charges and other credit risk provisions	39,737	16,361	22,283	141	(1,300)	77,222
Loan impairment charges and other credit risk provisions	(1,344)	(896)	165	-	11	(2,064)
Net operating income	38,393	15,465	22,448	141	(1,289)	75,158
Operating expenses	(16,932)	(5,424)	(9,642)	(113)	297	(31,814)
Operating profit	21,461	10,041	12,806	28	(992)	43,344
Share of profit in associates	179	1,090	446	-	190	1,905
Profit before tax	21,640	11,131	13,252	28	(802)	45,249

Customer Groups *(continued)*

(HK\$ millions)

	Personal Financial Services	Commercial Banking	Corporate, Investment Banking and Markets	Private Banking	Other	Total
2004						
Net interest income	20,785	7,065	11,258	35	(2,173)	36,970
Net fee income	7,524	4,111	5,012	42	(408)	16,281
Net trading income	617	520	5,795	5	66	7,003
Net investment income on assets backing policyholder liabilities	1,088	81	-	-	(271)	898
Gains less losses from financial investments	(13)	1	64	-	1,445	1,497
Dividend income	18	6	17	-	122	163
Net earned insurance premiums	13,186	751	148	-	-	14,085
Other operating income	2,439	449	883	1	342	4,114
Total operating income	45,644	12,984	23,177	83	(877)	81,011
Net insurance claims incurred and movement in policyholder liabilities	(11,441)	(191)	(93)	-	-	(11,725)
Net operating income before loan impairment charges and other credit risk provisions	34,203	12,793	23,084	83	(877)	69,286
Loan impairment charges and other credit risk provisions	(1,290)	638	1,519	-	(5)	862
Net operating income	32,913	13,431	24,603	83	(882)	70,148
Operating expenses	(15,659)	(4,784)	(7,288)	(74)	894	(26,911)
Operating profit	17,254	8,647	17,315	9	12	43,237
Share of profit in associates	73	170	20	-	36	299
Profit before tax	17,327	8,817	17,335	9	48	43,536

Net Interest Income

Net interest income of HK\$43,491 million was HK\$6,521 million, or 17.6 per cent, higher than in 2004.

Net interest income from the Personal Financial Services business rose by HK\$6,016 million, or 28.9 per cent, primarily due to improved deposit spreads resulting from rises in Hong Kong dollar and US dollar interest rates during 2005. This was coupled with strong growth in net interest income in the rest of Asia-Pacific, driven by increased mortgage lending in Australia, Korea, Singapore, Taiwan and India, and significant growth in credit card receivables particularly in Hong Kong, Taiwan and Indonesia. Net interest income from the Commercial Banking business was HK\$4,024 million, or 57.0 per cent, higher than last year, mainly due to growth in lending and deposits and improved deposit spreads in Hong Kong. Net interest income from Corporate, Investment Banking and Markets fell by HK\$2,533 million, or 22.5 per cent, largely due to the maturity of high yielding

treasury assets in Hong Kong, and flat yield curves that gave limited opportunity for position-taking. This was partly offset by the effect of the reclassification this year of net interest expense of HK\$1,484 million on trading assets and liabilities to 'Net trading income', which was made on adoption of the new accounting standards. Corporate lending grew in Hong Kong, mainland China, Korea and India, while deposit balances increased and spreads improved throughout the region. Included in net interest income in 2005 is income earned on held-to-maturity investments in the insurance businesses of HK\$1,692 million, which last year was classified as 'Net investment income on assets backing policyholder liabilities', and there has been a reclassification of HK\$505 million of net interest income to 'Net income from financial instruments designated at fair value'. Both of these reclassifications were made on adoption of the new accounting standards.

Financial Review (continued)

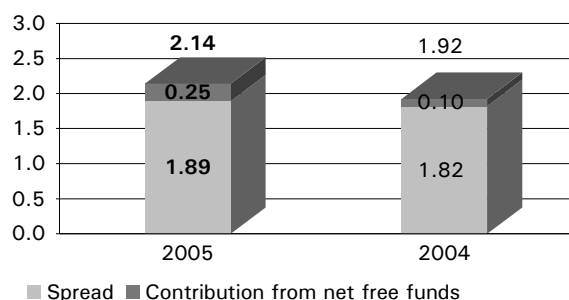
Net Interest Income (continued)

Average interest-earning assets rose by HK\$106.3 billion, or 5.5 per cent, to HK\$2,031.3 billion. Average advances to customers grew by HK\$102.5 billion, or 11.9 per cent, with strong growth in mortgage lending in Australia, Korea, Singapore, Taiwan and India, and increases in commercial lending and trade finance in Hong Kong. Credit card receivables rose in most countries, notably Hong Kong, Taiwan and Indonesia. Average loans to banks were HK\$90.8 billion higher, principally in the bank in Hong Kong, and lending to fellow subsidiaries rose by HK\$18.2 billion, but these increases were offset by the reclassification of certain interest-earning assets to 'Trading assets' on adoption of the new accounting standards.

(HK\$ millions)	2005	2004
Average interest-earning assets	2,031,314	1,925,044

The group's net interest margin of 2.14 per cent for 2005 was 22 basis points higher than 2004. The benefit to margin of the reclassification in 2005 of the net interest expense on trading assets and liabilities and net interest income from financial instruments designated at fair value was 24 basis points, and the inclusion of net interest income on held-to-maturity investments in the insurance businesses increased margin by four basis points. These benefits were, however, partly offset by higher funding costs as the rise in the number of preference shares issued and interest expense thereon, impacted margin by seven basis points. The contribution from net free funds rose by 15 basis points, reflecting the rise in Hong Kong dollar and US dollar interest rates in 2005.

Net interest margin (%)



For the banking operations in Hong Kong (excluding Hang Seng Bank), net interest margin increased by 46 basis points to 2.20 per cent for 2005. Spread improved by 28 basis points to 1.92 per cent.

This increase was principally due to the reclassification of net interest expense on net trading liabilities to net trading income. Wholesale rates increased significantly during the year as the surplus liquidity, which had kept rates depressed in prior years, was withdrawn from the system. Spreads on Hong Kong dollar and foreign currency current, savings and deposit accounts benefited, with an increase in the value of funds, although the effect was partly offset by a smaller increase in interest paid to customers. Spreads on mortgages, credit cards and corporate lending were adversely impacted by a higher cost of funds and competitive pressures on margins. The average yield on the residential mortgage portfolio, excluding Government Home Ownership Scheme ('GHOS') and staff loans, declined to 239 basis points below BLR in 2005 compared with 201 basis points below BLR in 2004. The contribution from net free funds rose by 18 basis points compared with the same period last year.

At Hang Seng Bank, net interest margin improved by 11 basis points to 2.19 per cent. The contribution from net free funds rose by 17 basis points, benefiting from the rise in market interest rates, while mortgage portfolio yields continued to be affected by market competition. The average yield on the residential mortgage portfolio, excluding GHOS and staff loans, fell to 225 basis points below BLR for 2005, compared with 202 basis points last year.

Net interest margin (%)

	2005	2004
Hong Kong:		
The bank	2.20	1.74
Hang Seng Bank	2.19	2.08
Rest of Asia-Pacific	2.00	1.96

In the rest of Asia-Pacific, net interest margin at 2.00 per cent for 2005 was four basis points higher than in 2004. Spread improved by four basis points to 1.85 per cent. All major sites faced an increase in funding costs, but margins rose in several countries, notably mainland China and Indonesia from higher yields on corporate lending, in India due to higher mortgage yields and an increase in low cost current account balances from custody and clearing customers, and in Australia from higher margins on personal lending. These increases were partly offset by lower margins on mortgage advances in Taiwan and Korea, and higher treasury funding costs in Singapore. The contribution from net free funds was unchanged at 15 basis points.

Net Fee Income

Net fee income was HK\$1,816 million, or 11.2 per cent, higher than 2004. Credit card fee income rose by 23.0 per cent, reflecting the increase in the number of cards in issue and higher cardholder spending. Customer demand for wealth management products slowed this year in Hong Kong, although the fall in demand for unit trusts was partially offset by increased sales of structured deposit products. The increase in contribution from the Bank of Bermuda businesses, following their integration into the group during the second half of last year, was HK\$967 million, principally from funds under management and securities/stockbroking, which also benefited from higher stock market turnover in Hong Kong and throughout the region. Credit facility fees decreased due to a change in accounting treatment whereby certain fees are now included as part of the effective interest rate and amortised through net interest income, rather than through net fee income as in prior years.

(HK\$ millions)	2005	2004
Account services	1,314	1,206
Credit facilities	1,159	1,447
Import/export	2,777	2,676
Remittances	1,248	1,103
Securities/stockbroking	3,402	2,842
Cards	4,231	3,439
Insurance	280	217
Unit trusts	1,627	2,488
Funds under management	2,233	1,216
Other	3,400	2,842
Fee income	21,671	19,476
Fee expense	(3,574)	(3,195)
Net fee income	18,097	16,281

Net Trading Income

Net trading income rose by 2.5 per cent to HK\$7,180 million. Foreign exchange profits benefited from higher exchange rate volatility and the group's growing customer franchise across the region. Debt securities trading benefited from correct positioning as short-term spreads on Hong Kong dollar bonds contracted in the low interest rate environment in the earlier part of 2005, but this was partly offset by losses on certain high yield bonds following the downgrading of companies in the automobile sector during the second quarter, and low volatility in credit spreads made for a difficult credit trading environment later in the year. Interest rate derivatives trading performed satisfactorily, reflecting an enhanced capability in structured products in Hong Kong, Korea and Singapore, which more than offset the fall in demand for wealth management products in Hong Kong as customers switched to deposit products in the higher interest rate environment. Equity and structured credit derivatives revenues also grew despite narrow credit spreads and low volatility in the market, and realised gains were made on the disposal of certain private equity investments.

Net interest expense on trading assets and liabilities largely represents interest payable on the group's own debt and structured deposits managed in the trading book, partly offset by interest income on debt securities. All such interest was classified under 'Net interest income' in prior years.

(HK\$ millions)	2005	2004
Dealing profits		
– Foreign exchange	5,548	4,680
– Interest rate derivatives	2,442	2,380
– Debt securities	278	(260)
– Equities and other trading	292	203
	8,560	7,003
Loss from hedging activities	(1)	–
Net interest expense on trading assets and liabilities	(1,484)	–
Dividend income from trading securities	105	–
Net trading income	7,180	7,003

Financial Review (continued)**Gains Less Losses from Financial Investments**

The profit on disposal of available-for-sale securities primarily comprises gains on the sale of equity securities, partly offset by losses on the disposal of US dollar bonds.

The profit on disposal of long-term investments in 2004 comprised gains from the sale of equity investments in Hong Kong.

In 2004, there was a partial write-back of a provision against an equity investment.

(HK\$ millions)	2005	2004
Profit on disposal of available-for-sale securities	762	-
Profit on disposal of long-term investments	-	1,311
Reversal of impairment of long-term investments	-	186
Other	(6)	-
Gains less losses from financial investments	756	1,497

Net Earned Insurance Premiums

Net premium income was HK\$5,255 million, or 37.3 per cent, higher than 2004, attributable to an enhanced range of life assurance and general insurance products, coupled with successful sales and marketing initiatives.

(HK\$ millions)	2005	2004
Gross insurance premium income	19,850	14,610
Less: reinsurance premiums	(510)	(525)
Net earned insurance premiums	19,340	14,085

Other Operating Income

Profit on disposal of subsidiaries and associates for 2005 comprises a gain made on the sale of HSBC Asset Management (Australia) Limited. Profit for 2004 included a gain on the exchange of the group's interest in World Finance International Limited, an associated company, for an interest in Bergesen Worldwide.

The surplus arising on property revaluation comprises gains on the revaluation of investment properties and the reversal of previous revaluation deficits that had arisen when the value of certain premises fell below depreciated historical cost. As permitted by the revised Hong Kong Accounting Standard 40, prior year profit and loss figures have not been restated to include revaluation gains on investment properties.

'Other' includes profits on the sale of a residential property in Hong Kong held on an operating lease, and miscellaneous income from fellow HSBC Group

subsidiary companies representing recoveries of shared operating costs.

(HK\$ millions)	2005	2004
Rental income from investment properties	215	211
Movement in present value of in force insurance business	1,185	833
Profit on disposal of property, plant and equipment	104	192
Profit on disposal of subsidiaries and associates	53	342
Surplus arising on property revaluation	1,537	1,038
Other	1,803	1,498
Other operating income	4,897	4,114

Loan Impairment Charges and Other Credit Risk Provisions

There was a net charge for loan impairment and other credit risk provisions of HK\$2,064 million compared with a net release of HK\$862 million in 2004. The charge for new individually assessed provisions was lower as credit card provisions were classified as individual in 2004, but collective in 2005. New

individually assessed provisions against mortgages and other personal lending fell, in line with the improving economy in Hong Kong, with lower bankruptcies, falling unemployment and a rise in property prices, although new provisions against commercial banking customers in Hong Kong increased. Releases and

Loan Impairment Charges and Other Credit Risk Provisions *(continued)*

recoveries were lower, largely relating to corporates in Hong Kong, Singapore and Thailand, but this was partly offset by higher releases against personal lending in Hong Kong and against lending to commercial banking customers in mainland China. There was a net charge for collectively assessed provisions, reflecting the reclassification of credit card provisions as collectively assessed, and a small charge against corporate lending, reflecting the rise in lending while the credit environment across the region was stable. The net charge for provisions against credit card lending rose by 35.3 per cent, attributable to the increase in delinquency levels in Taiwan, coupled with growth in receivables throughout the region.

Net charge/(release) for impairment provisions by region (HK\$ millions)

	2005	2004
Hong Kong	1,156	(1,680)
Rest of Asia-Pacific	924	912
Americas/Europe	(12)	(6)
Total	2,068	(774)

Net charge/(release) for impairment and other credit risk provisions (HK\$ millions)

	2005	2004
Advances to customers:		
– Individually assessed impairment provisions*		
New provisions	2,127	4,016
Releases	(1,755)	(2,450)
Recoveries	(267)	(617)
	105	949
– Collectively assessed impairment provisions**	1,961	(1,723)
– Country risk provisions	2	–
	2,068	(774)
Placements with banks maturing after one month:		
– Net release of individually assessed provisions	–	(1)
	2,068	(775)
– Net release of other credit risk provisions	(4)	(87)
Net charge/(release) to the income statement	2,064	(862)

* Individually assessed impairment provisions in 2004 refer to specific provisions.

** Collectively assessed impairment provisions in 2004 refer to general provisions.

Operating Expenses

Staff costs increased by HK\$2,971 million, or 20.1 per cent, compared with 2004, attributable to the increase in headcount throughout the region of 5,844. Staff numbers rose in all customer groups, notably in Personal Financial Services in India, Taiwan, Korea and Indonesia, in Commercial Banking in Hong Kong and mainland China, and in Corporate, Investment Banking and Markets as the build-up of the investment banking division in Hong Kong was substantially completed. Headcount in the Group Service Centre in Guangdong rose by more than 1,000 in order to support the expansion in processing work. Performance-related remuneration increased in line with the improved operating profits.

Staff numbers by region*

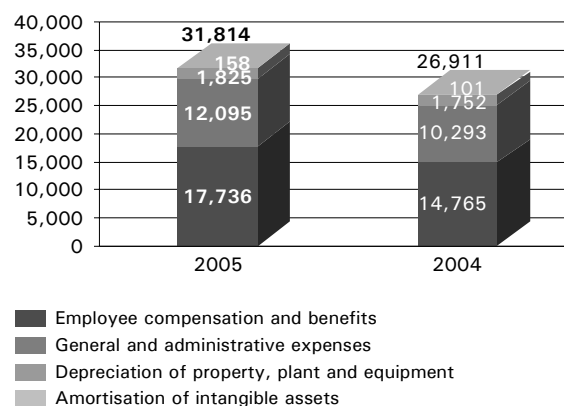
	2005	2004
Hong Kong:		
The bank and wholly owned subsidiaries	16,997	16,405
Hang Seng Bank	7,845	7,542
Total Hong Kong	24,842	23,947
Rest of Asia-Pacific:		
Australia	1,374	1,471
Mainland China	6,631	4,845
India	4,509	3,706
Indonesia	1,980	1,668
Singapore	2,121	1,908
Taiwan	2,143	1,725
Others	7,198	5,686
Total rest of Asia-Pacific	25,956	21,009
Americas/Europe	18	16
Total	50,816	44,972

* Full time equivalent

Financial Review (continued)**Operating Expenses** (continued)

The increase in general and administrative expenses of HK\$1,802 million, or 17.5 per cent, reflected additional costs incurred in business expansion throughout the region. Advertising and marketing expenditure increased in Hong Kong, Korea, Taiwan, Thailand and India, in line with the growth in the Personal Financial Services business in these countries. Technology costs increased as the group's growth initiatives required investment in systems and the development of distribution channels. Other general expenses, including rental, communications and travel costs increased in support of business expansion across the region.

	2005	2004
Cost efficiency ratio (%)	<u>41.2</u>	<u>38.8</u>

Operating expenses (HK\$ millions)**Share of Profit in Associates**

Share of profit in associates in 2005 included the group's share of post-tax profits from Bank of Communications and Industrial Bank, and amortisation of intangible assets arising on acquisition, for the 12 months to 30 September 2005. In 2004, this included share of profits and amortisation for the period from the date of acquisition (August 2004 and May 2004 for

Bank of Communications and Industrial Bank respectively) to 30 September 2004.

(HK\$ millions)	2005	2004
Share of profit in associates	<u>1,905</u>	<u>299</u>

Tax Expense

The effective rate of tax for 2005 was 17.8 per cent compared with 16.1 per cent in 2004, largely as a result of the interest expense on preference shares for which tax relief is not available, and a different product and geographic mix of taxable profits.

	2005	2004
Effective rate of tax (%)	<u>17.8</u>	<u>16.1</u>

Assets

Total assets increased by HK\$185.7 billion, or 7.5 per cent, since 31 December 2004.

Cash and short-term funds decreased by HK\$7.9 billion, or 1.5 per cent, due to the reclassification of treasury bills held for trading to 'Trading assets'.

Placings with banks maturing after one month fell by HK\$5.2 billion, or 6.9 per cent, notably in Hong Kong, attributable to the increase in customer lending and decrease in the commercial surplus.

Trading assets rose by HK\$127.9 billion, or 145.8 per cent, partly due to the reclassification of certain treasury bills from 'Cash and short-term funds'. Holdings of treasury bills and equity shares increased, largely in the bank in Hong Kong, while debt securities rose on acquisition of HSBC Securities (Japan) from another HSBC group company. Trading assets also include stock borrowing balances and lending under reverse repurchase agreements which have been reclassified from 'Advances to customers'.

Assets (continued)

Financial investments decreased by HK\$77.8 billion, or 16.5 per cent, partly attributable to the reclassification of certain assets to 'Financial assets designated at fair value'. Holdings of debt securities reduced, reflecting the decrease in the commercial surplus in Hong Kong, and disposals of US dollar bonds in Japan.

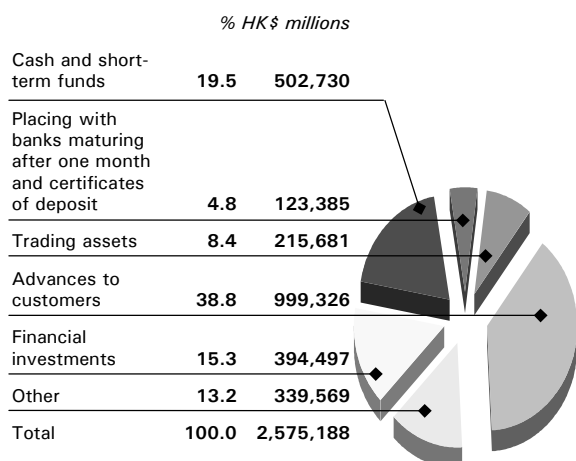
Advances to customers increased by HK\$80.1 billion, or 8.7 per cent, since the end of 2004.

Advances in Hong Kong grew by HK\$31.3 billion, or 5.3 per cent, since the end of 2004, on account of the buoyant economy. Mortgage lending fell, attributable to persistent price competition in a flat market, and lending under the GHOS continued to decline as the scheme remained suspended during 2005. Other

personal lending rose, mainly on credit cards, reflecting the increase in cardholder spending. Corporate and commercial lending rose by 11.0 per cent, with particularly strong growth in the manufacturing sector and property investment.

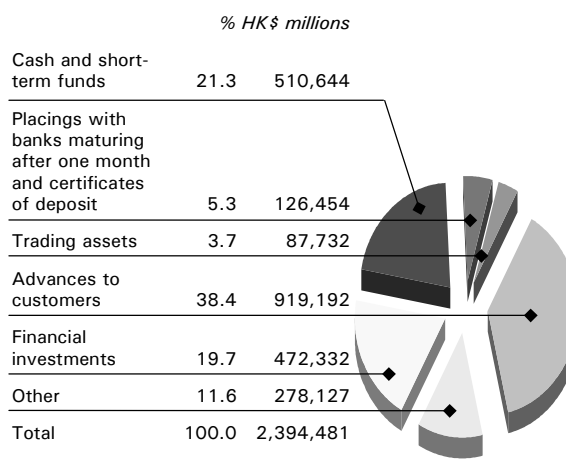
In the rest of Asia-Pacific, advances rose by HK\$48.8 billion, or 14.8 per cent, since the end of 2004, reflecting successful business expansion across the region. Mortgage advances increased by 19.0 per cent, principally in Korea, Singapore, Taiwan and India. Credit card receivables grew by 31.7 per cent, largely in Taiwan, Indonesia, the Philippines and India. Lending to corporate and commercial customers rose by 9.1 per cent, most significantly in mainland China, Korea and India.

Assets 2005*



* Excluding Hong Kong SAR Government certificates of indebtedness

Assets 2004*



Customer Accounts

Customer accounts increased by HK\$7.0 billion compared with the end of 2004.

Certain structured deposits that were previously recorded in 'Other deposit accounts' have, in

accordance with revised accounting standards, been reclassified in 2005 to 'Trading liabilities'. Excluding the effect of this reclassification, customer accounts rose by HK\$84.4 billion, or 4.9 per cent.

Financial Review (continued)

Customer Accounts (continued)

Customer accounts 2005

	% HK\$ millions	
Hong Kong excluding Hang Seng Bank	48.7	844,779
Hang Seng Bank	24.8	430,828
Total Hong Kong	73.5	1,275,607
Rest of Asia-Pacific	26.3	456,652
Americas/Europe	0.2	2,851
Total	100.0	1,735,110

In Hong Kong, customer accounts, including accounts reclassified as trading, increased by HK\$19.8 billion, or 1.5 per cent. Current accounts and demand deposits fell by HK\$161.2 billion reflecting the shift into savings and time deposits as interest rates rose during 2005, coupled with a net outflow of deposits from personal customers attributable to intense market competition in the higher interest rate environment. Customer account balances, including trading accounts, in Commercial Banking and Corporate, Investment Banking and Markets increased by HK\$42.9 billion, or 10.2 per cent, reflecting the success of the group's cash management capabilities in attracting new deposits from small and larger businesses alike.

In the rest of Asia-Pacific, customer accounts, including trading accounts, rose by HK\$65.0 billion, or

Customer accounts 2005

	% HK\$ millions	
Current accounts and demand deposits	53.3	925,008
Savings accounts	38.3	664,478
Other deposit accounts	8.4	145,624
Total	100.0	1,735,110

Equity

Equity increased by HK\$14.3 billion, or 14.3 per cent, to HK\$114.4 billion. The increase was principally due

Customer accounts 2004

	% HK\$ millions	
Hong Kong excluding Hang Seng Bank	50.0	864,799
Hang Seng Bank	25.9	447,295
Total Hong Kong	75.9	1,312,094
Rest of Asia-Pacific	23.9	412,780
Americas/Europe	0.2	3,237
Total	100.0	1,728,111

15.7 per cent. Deposits from personal customers increased by 8.5 per cent, notably in mainland China, Singapore and Indonesia. Deposits in Commercial Banking and Corporate, Investment Banking and Markets grew by 19.6 per cent, with increases in mainland China, India, Korea, Singapore, Brunei and Taiwan, attributable to business expansion, particularly in the payments and cash management business, and higher balances from securities custody and clearing customers.

The group's advances-to-deposits ratio increased to 57.6 per cent at 31 December 2005 from 53.2 per cent at 31 December 2004.

	2005	2004
Advances: deposits ratio (%)	57.6	53.2

Customer accounts 2004

	% HK\$ millions	
Current accounts and demand deposits	61.8	1,069,178
Savings accounts	29.9	516,237
Other deposit accounts	8.3	142,696
Total	100.0	1,728,111

to the increase in retained profits for the year.

Capital Adequacy

The Hong Kong Monetary Authority ('HKMA') is the supervisor of the group on a consolidated basis. In this capacity, the HKMA sets minimum capital requirements for the group and the bank and receives regular returns on capital adequacy. The HKMA broadly applies the guidelines for the international convergence of capital measurement and standards laid down by the Group of Ten central banks commonly known as the Basel Committee. Since the end of 1997, the capital adequacy rules have incorporated additional requirements for market risks which comprise foreign exchange, interest rate and equity risks.

The table on the right sets out an analysis of regulatory capital and capital adequacy ratios for the group at the end of 2005 and 2004.

The group's total capital adequacy ratio increased from 11.9 per cent at 31 December 2004 to 12.4 per cent at 31 December 2005.

Capital adequacy ratios including market risks and calculated in accordance with the Third Schedule of the Hong Kong Banking Ordinance are both shown in Note 47 on the Accounts on page 141.

(HK\$ millions)	2005	2004
Composition of capital		
Tier 1:		
Shareholders' funds	97,334	147,495
Less: proposed dividend	(4,500)	(4,800)
property revaluation reserves*	(7,892)	(11,907)
available-for-sale investments and equity revaluation reserves**	(3,051)	(1,609)
classified as regulatory reserve***	(1,319)	-
term preference shares	-	(3,886)
goodwill	(3,784)	(5,771)
others	1,769	-
Irredeemable non-cumulative preference shares	51,587	-
Minority interests****	14,808	14,384
Total qualifying tier 1 capital	<u>144,952</u>	<u>133,906</u>
Tier 2:		
Property revaluation reserves (@70%)	5,524	7,977
Available-for-sale investments and equity revaluation reserves (@70%)	2,136	1,126
Collective impairment provision and regulatory reserve	5,112	2,447
Perpetual subordinated debt	9,359	9,328
Term subordinated debt	6,117	1,814
Term preference shares	3,877	3,109
Irredeemable cumulative preference shares	16,516	-
Total qualifying tier 2 capital	<u>48,641</u>	<u>25,801</u>
Deductions	<u>(39,528)</u>	<u>(20,251)</u>
Total capital	<u>154,065</u>	<u>139,456</u>
Risk-weighted assets	<u>1,238,164</u>	<u>1,173,432</u>
Capital adequacy ratios		
Total capital/risk-weighted assets (%)	12.4	11.9
Tier 1 capital/risk-weighted assets (%)	11.7	11.4

* Includes the revaluation surplus on investment properties, which is now reported as part of retained profits.

** Includes adjustments made in accordance with guidelines issued by HKMA.

*** The regulatory reserve is maintained for the purpose of satisfying the Banking Ordinance for prudential supervision. Movements in this reserve are made in consultation with the HKMA.

**** After deduction of minority interests in unconsolidated subsidiary companies.

Financial Review (continued)**Overdue and rescheduled advances**

Overdue and rescheduled advances are shown in Notes 16c and 16d on the Accounts respectively on pages 89 to 91.

Analysis of advances to customers by geographic areas according to the location of counterparties, after risk transfer (HK\$ millions)

	Hong Kong	Rest of Asia- Pacific	Americas/ Europe	Others	Total
At 31 December 2005					
Gross advances to customers	570,329	354,626	73,959	6,988	1,005,902
Overdue advances to customers	2,337	2,222	223	8	4,790
At 31 December 2004					
Gross advances to customers	543,997	319,512	59,461	4,151	927,121
Overdue advances to customers	3,212	2,343	74	-	5,629

Cross-Border Exposure

The country risk exposures in the tables below are prepared in accordance with the HKMA Return of External Positions Part II: Cross-Border Claims (MA(BS)9) guidelines.

Cross-border claims are on-balance sheet exposures to counterparties based on the location of the counterparties after taking into account the transfer of risk.

The tables show claims on individual countries and territories or areas, after risk transfer, amounting to 10 per cent or more of the aggregate cross-border claims.

Cross-border risk is controlled centrally through a well-developed system of country limits and is frequently reviewed to avoid concentration of transfer, economic or political risk.

As at 31 December 2005

	Banks and Other Financial Institutions	Public Sector Entities	Other	Total
(HK\$ millions)				
Americas				
United States	38,673	72,477	34,515	145,665
Other	39,328	9,909	50,744	99,981
	<u>78,001</u>	<u>82,386</u>	<u>85,259</u>	<u>245,646</u>
Europe				
United Kingdom	111,377	14	22,232	133,623
Other	338,060	5,842	39,509	383,411
	<u>449,437</u>	<u>5,856</u>	<u>61,741</u>	<u>517,034</u>
Asia-Pacific excluding Hong Kong				
	154,135	33,897	108,476	296,508

As at 31 December 2004

	Banks and Other Financial Institutions	Public Sector Entities	Other	Total
(HK\$ millions)				
Americas				
United States	45,518	80,047	32,010	157,575
Other	43,044	16,143	47,297	106,484
	<u>88,562</u>	<u>96,190</u>	<u>79,307</u>	<u>264,059</u>
Europe				
United Kingdom	86,613	27	23,294	109,934
Other	332,581	4,219	22,168	358,968
	<u>419,194</u>	<u>4,246</u>	<u>45,462</u>	<u>468,902</u>
Asia-Pacific excluding Hong Kong				
	151,183	18,454	77,266	246,903

Risk Management

The group's activities involve the analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The principal types of risk faced by the group are credit risk (which includes country and cross-border risk), liquidity risk, market risk, operational risk and reputational risk. Market risk includes foreign exchange, interest rate and equity price risk.

The HSBC Group Head Office formulates high-

level risk management policies for the HSBC Group worldwide. The group's risk management policies and procedures are subject to a high degree of oversight and guidance to ensure that all types of risk are systematically identified, measured, analysed and actively managed.

Credit risk, liquidity risk and market risk are discussed in detail in Note 50 on the Accounts on pages 147 to 152.

Market Risk Management

The nature of market risk and the principal tool used to monitor and limit market risk exposure (value at risk) are discussed in Note 50 on the Accounts on pages 149 to 152.

The average daily revenue earned from market risk-related treasury activities in 2005, including accrual book net interest income and funding related to dealing positions, was HK\$44 million compared with HK\$52 million in 2004. The standard deviation of these daily revenues was HK\$31 million (HK\$30 million for 2004).

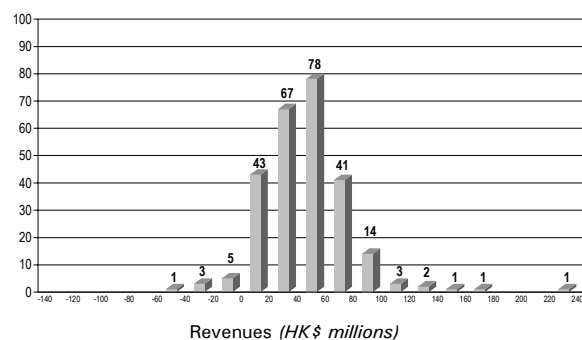
An analysis of the frequency distribution of daily revenues shows a maximum daily loss of HK\$55 million with nine out of 260 days showing negative

revenues in 2005. The most frequent result was a daily revenue of between HK\$40 million and HK\$60 million with 78 occurrences. The highest daily revenue was HK\$223 million. In 2004, the maximum daily loss was HK\$122 million with seven out of 262 days showing negative revenues. The most frequent result in 2004 was between HK\$40 million and HK\$60 million with 69 occurrences. The highest daily revenue in 2004 was HK\$156 million.

The average one-day foreign exchange dealing profit for 2005 was HK\$10 million (HK\$14 million for 2004), and the average daily revenue earned from treasury-related interest rate activities for 2005 was HK\$34 million (HK\$38 million for 2004).

Daily distribution of market risk revenues 2005

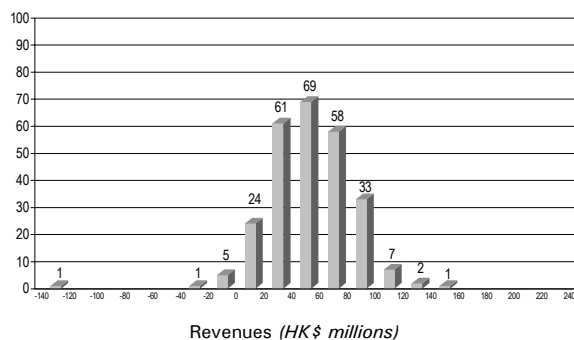
Number of days



■ Profit and loss frequency

Daily distribution of market risk revenues 2004

Number of days



Operational Risk Management

Operational risk is the risk of loss arising through fraud, unauthorised activities, error, omission, inefficiency, systems failure or from external events. It is inherent to every business organisation and covers a wide spectrum of issues.

The group manages this risk through a controls-based environment in which processes are documented,

authorisation is independent and transactions are reconciled and monitored. This is supported by an independent programme of periodic reviews undertaken by internal audit, and by monitoring external operational risk events, which ensure that the group stays in line with best practice and takes account of lessons learned from publicised operational failures within the financial services industry.

Financial Review (continued)

Operational Risk Management (continued)

The HSBC Group codified its operational risk management process by issuing a high level standard, supplemented by more detailed formal guidance issued in January 2005. This explains how the group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, and implementing any additional procedures required for compliance with local regulatory requirements. The standard covers the following:

- operational risk management responsibility is assigned at senior management level within the business operation;
- information systems are used to record the identification and assessment of operational risks and generate appropriate, regular management reporting;
- assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessment

incorporates a regular review of identified risks to monitor significant changes;

- operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the group Audit Committee; and
- risk mitigation, including insurance, is considered where this is cost-effective.

The group maintains and tests contingency facilities to support operations in the event of disasters. Additional reviews and tests are conducted in the event that any HSBC office is affected by a business disruption event, to incorporate lessons learned in the operational recovery from those circumstances. Plans have been prepared for the continued operation of the group's business, with reduced staffing levels, should a flu pandemic occur.

Reputational Risk Management

Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events.

Reputational risks are considered and assessed by the senior management. Standards on all major aspects of business are set by the HSBC Group Head Office. These policies, which are an integral part of the internal control systems, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies set out operational procedures in all areas of reputational

risk, including money laundering deterrence, environmental impact, anti-corruption measures and employee relations.

Management in all operating entities is required to establish a strong internal control structure to minimise the risk of operational and financial failure, and to ensure that a full appraisal of reputational implications is made before strategic decisions are taken. The HSBC Group's internal audit function monitors compliance with policies and standards.

Consolidated Income Statement for the Year Ended 31 December 2005

	Note	2005 HK\$m	2004 HK\$m Restated
Interest income	4a	80,199	57,947
Interest expense	4b	<u>(36,708)</u>	<u>(20,977)</u>
Net interest income		43,491	36,970
Fee income		21,671	19,476
Fee expense		<u>(3,574)</u>	<u>(3,195)</u>
Net fee income		18,097	16,281
Net trading income	4c	7,180	7,003
Net income from financial instruments designated at fair value	4d	384	–
Net investment income on assets backing policyholder liabilities	4d	–	898
Gains less losses from financial investments	4e	756	1,497
Dividend income	4f	368	163
Net earned insurance premiums	4g	19,340	14,085
Other operating income	4h	<u>4,897</u>	<u>4,114</u>
Total operating income		94,513	81,011
Net insurance claims incurred and movement in policyholder liabilities	4i	<u>(17,291)</u>	<u>(11,725)</u>
Net operating income before loan impairment charges and other credit risk provisions		77,222	69,286
Loan impairment charges and other credit risk provisions	4j	<u>(2,064)</u>	<u>862</u>
Net operating income		75,158	70,148
Employee compensation and benefits	4k	(17,736)	(14,765)
General and administrative expenses	4l	(12,095)	(10,293)
Depreciation of property, plant and equipment		(1,825)	(1,752)
Amortisation of intangible assets		<u>(158)</u>	<u>(101)</u>
Total operating expenses		(31,814)	(26,911)
Operating profit		43,344	43,237
Share of profit in associates		<u>1,905</u>	<u>299</u>
Profit before tax		45,249	43,536
Tax expense	5	<u>(8,051)</u>	<u>(6,988)</u>
Profit for the year		<u>37,198</u>	<u>36,548</u>
Attributable to shareholders		32,873	32,148
Attributable to minority interests		4,325	4,400

Consolidated Balance Sheet at 31 December 2005

	<i>Note</i>	2005 HK\$m	2004 HK\$m Restated
ASSETS			
Cash and short-term funds	8	502,730	510,644
Placings with banks maturing after one month	9	69,554	74,711
Items in the course of collection from other banks		17,782	13,479
Certificates of deposit	10	53,831	51,743
Hong Kong SAR Government certificates of indebtedness	11	97,344	92,334
Trading assets	12	215,681	87,732
Financial assets designated at fair value	13	37,073	–
Derivatives	14	72,039	94,398
Advances to customers	15	999,326	919,192
Financial investments	17	394,497	472,332
Amounts due from fellow subsidiary companies		101,173	82,592
Investments in associates	19	23,061	16,343
Goodwill and intangible assets	20	7,252	5,329
Property, plant and equipment	21	29,805	27,204
Deferred tax assets	31	1,272	1,711
Retirement benefit assets	4k	1,788	1,307
Other assets	23	48,324	35,764
Total assets		2,672,532	2,486,815
LIABILITIES			
Hong Kong SAR currency notes in circulation	11	97,344	92,334
Deposits by banks	24	83,802	74,980
Customer accounts	25	1,735,110	1,728,111
Items in the course of transmission to other banks		20,927	23,452
Trading liabilities	26	250,198	37,281
Financial liabilities designated at fair value	27	2,927	–
Derivatives	14	72,009	92,362
Debt securities in issue	28	61,468	155,162
Retirement benefit liabilities	4k	394	327
Amounts due to fellow subsidiary companies		22,275	17,568
Amounts due to ultimate holding company		2,502	553
Other liabilities	29	46,628	37,158
Liabilities to customers under investment contracts		30,364	28,516
Liabilities under insurance contracts issued	30	41,845	26,422
Current taxation	5	2,044	2,333
Deferred taxation	31	3,729	3,395
Subordinated liabilities	33	12,561	11,142
Preference shares	34	71,980	55,602
Total liabilities		2,558,107	2,386,698
EQUITY			
Share capital	35	22,494	22,494
Other reserves	36	6,037	6,029
Retained profits	36	64,303	50,484
Proposed final interim dividend	7	4,500	4,800
Shareholders' funds		97,334	83,807
Minority interests		17,091	16,310
		114,425	100,117
Total equity and liabilities		2,672,532	2,486,815

Directors

Vincent H C Cheng
Michael R P Smith
Peter T S Wong

Secretary

M W Scales
6 March 2006

Balance Sheet at 31 December 2005

	<i>Note</i>	2005 HK\$m	2004 HK\$m Restated
ASSETS			
Cash and short-term funds	8	430,129	434,583
Placings with banks maturing after one month	9	53,205	56,543
Items in the course of collection from other banks		9,705	9,007
Certificates of deposit	10	23,001	12,441
Hong Kong SAR Government certificates of indebtedness	11	97,344	92,334
Trading assets	12	173,169	83,723
Financial assets designated at fair value	13	8,755	–
Derivatives	14	70,328	92,092
Advances to customers	15	664,645	597,674
Financial investments	17	196,684	273,549
Amounts due from subsidiary companies		23,571	19,062
Amounts due from fellow subsidiary companies		96,406	79,721
Investments in subsidiary companies	18	6,248	4,120
Investments in associates	19	17,242	13,864
Goodwill and intangible assets	20	1,571	1,114
Property, plant and equipment	21	15,281	15,288
Deferred tax assets	31	782	1,120
Retirement benefit assets	4k	1,252	1,026
Other assets	23	37,501	28,179
Total assets		<u>1,926,819</u>	<u>1,815,440</u>
LIABILITIES			
Hong Kong SAR currency notes in circulation	11	97,344	92,334
Deposits by banks	24	75,674	66,197
Customer accounts	25	1,247,079	1,228,680
Items in the course of transmission to other banks		14,317	17,234
Trading liabilities	26	175,127	31,439
Financial liabilities designated at fair value	27	1,959	–
Derivatives	14	71,410	90,479
Debt securities in issue	28	21,267	108,413
Retirement benefit liabilities	4k	379	320
Amounts due to subsidiary companies		20,773	13,583
Amounts due to fellow subsidiary companies		19,169	15,941
Amounts due to ultimate holding company		2,477	525
Other liabilities	29	37,690	29,735
Current taxation	5	1,457	1,706
Deferred taxation	31	1,238	1,405
Subordinated liabilities	33	9,703	9,686
Preference shares	34	71,980	55,602
Total liabilities		<u>1,869,043</u>	<u>1,763,279</u>
EQUITY			
Share capital	35	22,494	22,494
Other reserves	36	786	1,741
Retained profits	36	29,996	23,126
Proposed final interim dividend	7	4,500	4,800
Shareholders' funds		57,776	52,161
Total equity and liabilities		<u>1,926,819</u>	<u>1,815,440</u>

Directors

Vincent H C Cheng
Michael R P Smith
Peter T S Wong

Secretary

M W Scales
6 March 2006

Consolidated Statement of Changes in Equity For the Year Ended 31 December 2005

	2005 HK\$m	2004 HK\$m Restated
Called up share capital		
Balance at beginning of the period		
– As previously reported	74,213	51,603
– Effect of transition to HKFRS	<u>(51,719)</u>	<u>(35,349)</u>
– As restated	22,494	16,254
New ordinary shares issued	<u>–</u>	<u>6,240</u>
Balance at the end of the period	<u>22,494</u>	<u>22,494</u>
Property revaluation reserve		
Balance at beginning of the period		
– As previously reported	11,907	7,135
– Effect of transition to HKFRS	<u>(8,842)</u>	<u>(4,817)</u>
– As restated	3,065	2,318
Unrealised surplus on revaluation	2,053	559
Transfer of depreciation from retained profits	(173)	(157)
Transfer from retained profits	–	876
Realisation on disposal of properties	(523)	(417)
Deferred tax and other movements	<u>(340)</u>	<u>(114)</u>
Balance at the end of the period	<u>4,082</u>	<u>3,065</u>
Other reserves		
Balance at beginning of the period		
– As previously reported	5,492	5,060
– Effect of transition to HKFRS (excluding the effect of HKAS 39)	<u>(2,528)</u>	<u>(3,697)</u>
– As restated	2,964	1,363
– Effect on adoption of HKAS 39	<u>1,333</u>	<u>–</u>
– As restated	4,297	1,363
Long-term equity investments:		
Fair value gains taken to equity	–	1,610
Transfer to income statement on disposal	–	(1,033)
Deferred tax and other movements	–	(43)
Available-for-sale investments:		
Fair value losses taken to equity	(1,317)	–
Transfer to income statement on disposal	(587)	–
Transfer to income statement on change in fair value of the of hedged items	983	–
Deferred tax and other movements	6	–
Share of associates' available-for-sale reserve	557	–
Cashflow hedges:		
Fair value losses taken to equity	(2,522)	–
Transfer to income statement	538	–
Deferred tax and other movements	342	–
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	(790)	843
Employees' options granted cost free by ultimate holding company	307	224
Exchange and other movements	<u>141</u>	<u>–</u>
Balance at the end of the period	<u>1,955</u>	<u>2,964</u>

	2005 HK\$m	2004 HK\$m Restated
Retained profits		
Balance at beginning of the period		
– As previously reported	51,083	37,764
– Effect of transition to HKFRS (excluding the effect of HKAS 39)	<u>(599)</u>	<u>1,235</u>
– As restated	50,484	38,999
– Effect on adoption of HKAS 39	<u>(39)</u>	<u>–</u>
– As restated	50,445	38,999
Profit for the year attributable to shareholders	32,873	32,148
Dividends	(20,300)	(20,300)
Transfer of depreciation to property revaluation reserve	173	157
Transfer to property revaluation reserve	–	(876)
Realisation on disposal of properties	523	417
Actuarial gains/(losses) on defined benefit plans	73	(453)
Deferred tax and other movements	<u>516</u>	<u>392</u>
Balance at the end of the period	<u>64,303</u>	<u>50,484</u>
Dividend declared but not yet approved	<u>4,500</u>	<u>4,800</u>

The following table shows an analysis of the changes in equity attributable to minority interests:

	2005 HK\$m	2004 HK\$m Restated
Balance at the beginning of the period		
– As previously reported	16,360	15,991
– Effect of transition to HKFRS (excluding the effect of HKAS 39)	<u>(50)</u>	<u>(279)</u>
– As restated	16,310	15,712
– Effect on adoption of HKAS 39	<u>348</u>	<u>–</u>
– As restated	16,658	15,712
Profit attributable to minority interests	4,325	4,400
Dividends	(3,983)	(3,787)
Increase in stake and other movements	<u>91</u>	<u>(15)</u>
Balance at the end of the period	<u>17,091</u>	<u>16,310</u>

Consolidated Cash Flow Statement for the Year Ended 31 December 2005

	<i>Note</i>	2005 HK\$m	2004 HK\$m
Operating activities			Restated
Cash generated from operations	39	31,009	120,557
Interest received on financial investments		14,759	12,780
Dividends received on financial investments		339	187
Dividends received from associates		108	52
Taxation paid		<u>(7,313)</u>	<u>(5,083)</u>
Net cash inflow from operating activities		<u>38,902</u>	<u>128,493</u>
Investing activities			
Purchase of financial investments		(335,668)	(289,647)
Proceeds from sale or redemption of financial investments		366,294	269,007
Purchase of property, plant and equipment		(1,749)	(1,369)
Proceeds from sale of property, plant and equipment		1,153	846
Purchase of other intangibles		(670)	(101)
Net cash outflow in respect of acquisition of and increased shareholding in subsidiary companies	40c	(1,644)	(972)
Net cash inflow in respect of sale of subsidiary companies	40d	151	39
Net cash outflow in respect of purchase of business		–	(588)
Net cash outflow in respect of purchase of interest in associates		(3,358)	(15,415)
Proceeds from sale of interest in associates		<u>10</u>	<u>12</u>
Net cash inflow/(outflow) from investing activities		<u>24,519</u>	<u>(38,188)</u>
Net cash inflow before financing		<u>63,421</u>	<u>90,305</u>
Financing			
Issue of ordinary share capital		–	6,240
Issue of non-cumulative irredeemable preference shares		–	16,356
Issue of cumulative irredeemable preference shares		16,567	–
Increase of non-equity minority interests		362	–
Repayment of loan capital		–	(1,771)
Issue of subordinated liabilities		2,500	–
Ordinary dividends paid		(20,600)	(23,950)
Dividends paid to minority interests		(3,983)	(3,787)
Interest paid on preference shares		(1,574)	(1,269)
Interest paid on loan capital		<u>(555)</u>	<u>(576)</u>
Net cash outflow from financing		<u>(7,283)</u>	<u>(8,757)</u>
Increase in cash and cash equivalents	40a	<u>56,138</u>	<u>81,548</u>

Notes on the Accounts

1 Basis of preparation

- a** The consolidated financial statements comprise the accounts of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiary companies ('the group') made up to 31 December.

The consolidated financial statements have been prepared in accordance with all Hong Kong Financial Reporting Standards ('HKFRS'), the provisions of the Hong Kong Companies Ordinance and accounting principles generally accepted in Hong Kong. HKFRS is a collective term which includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ('HKAS') and Interpretations issued by the Hong Kong Institute of Certified Public Accountants ('HKICPA').

The consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of certain financial assets and liabilities and premises.

- b** The consolidated accounts include the attributable share of the results and reserves of associates based on accounts made up to dates not earlier than three months prior to 31 December.

2 Nature of business

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

2A Adoption of new and revised HKFRS

In the current year, the group has adopted all new and revised HKFRS that are relevant to its operations and are effective for accounting periods beginning on 1 January 2005. The adoption of the new and revised HKFRS has resulted in changes in the group's accounting policies that have affected the amounts reported for the current and prior years. The accounting policies applied by the group following the adoption of the new and revised HKFRS are set out in Note 3.

A description of the significant changes from accounting policies previously applied by the group together with estimates, to the extent practicable, of the amounts involved are set out below.

Changes in accounting policies have generally been applied retrospectively except as noted below. Retrospective application of a new accounting policy involves restating the comparative figures and restating the opening balance sheet as at 1 January 2004 as if the new policy had always been applied.

Some standards specify transitional provisions governing the initial application of the standard. In some cases transitional provisions restrict the extent to which a change in accounting policy may be applied retrospectively. The most significant exception to retrospective application is HKAS 39 – Financial instruments: recognition and measurement. As explained more fully in Note 2Ab below, the new accounting policies for recognition and measurement of financial instruments are applied with effect from 1 January 2005. This means that, among other things, interest income and expense, hedging transactions, and related financial assets and liabilities, including those designated at fair value, are recognised and measured on different bases in 2005 from those which apply to the comparative figures for 2004.

a *HKAS 32 – Financial instruments: disclosure and presentation*

Application of HKAS 32 has resulted in the reclassification of preference shares issued by the Bank from share capital to liabilities. This has had the effect of increasing liabilities and reducing equity at 31 December 2005 by HK\$71,980 million (2004: HK\$55,602 million). In addition, dividends payable on those preference shares have been reclassified as interest expense whereas they were previously dealt with as an appropriation of retained earnings. This has reduced 'Net interest income' and 'Operating profit' in 2005 by HK\$3,010 million (2004: HK\$1,540 million).

HKAS 32 also requires that financial assets and liabilities may only be offset in the circumstances described in Note 3I. This resulted in a grossing up of assets and liabilities by HK\$57,718 million at 31 December 2005 (2004: HK\$52,157 million). This adjustment had no effect on reported profit or equity.

Notes on the Accounts (continued)

2A Adoption of new and revised HKFRS (continued)

b HKAS 39 – Financial instruments: recognition and measurement

HKAS 39 sets requirements for the classification, recognition, measurement and derecognition of financial instruments as well as hedge accounting. These requirements affect the measurement and timing of income and expenses associated with many of the activities of the group as well as the carrying values of financial assets and liabilities in the balance sheet.

The new accounting policies resulting from the application of HKAS 39 are set out in Note 3. Where the accounting policies have changed as a result of the application of HKAS 39, the previous policies have also been disclosed.

The transitional provisions of HKAS 39 prohibit full retrospective application of the standard and instead require the adjustments to the carrying values of all financial instruments on initial application of the standard to be made in the opening balance sheet as at 1 January 2005. This means that the recognition and measurement of certain financial instruments, together with associated income and expenses for 2005 is not necessarily consistent with the amounts reported for 2004.

The more significant changes in the 2005 financial statements resulting from HKAS 39 include (but are not limited to) the following:

- Effective interest rate method (Note 3a & b)

HKAS 39 requires the use of the effective interest rate method for calculating interest income and the amount of amortisation of premiums, discounts and transaction costs associated with debt instruments. This affects the timing of recognition of certain types of fee income and expense as well as their reclassification to 'Net interest income'.

- Derivatives and hedging (Note 3j)

HKAS 39 requires all derivatives to be recognised on the balance sheet at fair (market) value regardless of the purpose for which they are held. In addition, the rules for applying hedge accounting under HKAS 39 are more restrictive than the policies previously applied by the group. This results in fewer transactions qualifying for hedge accounting in 2005 compared to previously, while the gains and losses on the derivatives are now generally recognised in 'Net trading income'.

- Acceptances and endorsements

HKAS 39 requires that assets and liabilities associated with acceptances and endorsements related to trade finance should be recognised on the balance sheet. This results in an increase in both 'Other assets' and 'Other liabilities' of HK\$22,744 million. Under the previous accounting policies, these items had been disclosed as off-balance sheet 'Contingent liabilities and commitments'. This change has no effect on profit for the year.

- Fair value measurement

HKAS 39 generally requires treasury bills and debt securities intended to be held on a continuing basis to be carried at fair value in the balance sheet. Unless the securities are designated under the 'fair value option' (see below), then the changes in fair value are recognised in equity until the securities are sold. These securities were previously carried at cost.

In addition the group has early-adopted the 'Amendment to HKAS 39 – The fair value option' in 2005. This allows financial assets and liabilities, under certain restricted circumstances, to be designated at fair value with changes in fair value being recognised in the income statement as they arise. This is described in Note 3f. There was no such category in 2004.

2A Adoption of new and revised HKFRS (continued)

Upon initial application of HKAS 39 in 2005, the following financial assets and liabilities were designated at fair value under the 'fair value option':

<i>Fair value at 1 January 2005</i>	<u>Group</u>	<u>Bank</u>
	HK\$m	HK\$m
Assets		
Customer advances	3,807	3,807
Treasury bills	1,318	–
Debt securities	15,976	6,409
Equity shares	14,971	–
	<u>36,072</u>	<u>10,216</u>
Liabilities		
Customer accounts	1,252	1,252
Deposits by banks	2	–
	<u>1,254</u>	<u>1,252</u>

Effect of HKAS 39 on the income statement

To the extent practicable, management has estimated the effect of applying HKAS 39 on the group's income statement in 2005 as follows:

<i>Estimated effect of applying HKAS 39:</i>	HK\$m
Increase in net interest income	1,076
Decrease in net fee income	(298)
Decrease in net trading income	(957)
Increase in net income from financial instruments designated at fair value	372
Increase in gains less losses from financial investments	139
Decrease in dividend income	(105)
Increase in loan impairment charges and other credit risk provisions	(53)
Increase in net operating income	174
Decrease in operating expenses	193
Increase in profit before tax	<u>367</u>

Notes on the Accounts (continued)

2A Adoption of new and revised HKFRS (continued)

c HKFRS 4 – Insurance contracts

HKFRS 4 introduced a formal definition of the term ‘Insurance contract’. Application of this standard has materially affected the financial statements in the manner set out below.

- Certain contracts issued by the group which have the legal form of insurance contracts do not meet the definition of insurance contracts in HKFRS 4. The assets, liabilities, income and expenses associated with such contracts are dealt with as investment contracts and from 1 January 2005, are accounted for under HKAS 39.
- Reclassification of items relating to the insurance business
 - Financial assets held by insurance subsidiaries were previously reported as ‘Other assets’. These financial assets have been disaggregated and classified into their respective categories. Measurement of such assets is also in accordance with HKAS 39 with effect from 1 January 2005.
 - The income statement captions ‘Net earned insurance premiums’ and ‘Net insurance claims incurred and movement in policyholder liabilities’ include only the amounts relating to insurance contracts as defined under HKFRS 4. Income and expenses relating to contracts which are, in substance, investment contracts are included in other income statement captions according to their nature. Income from related assets is included in ‘Net interest income’ and ‘Net income from financial instruments designated at fair value’. The related assets are included in the balance sheet under ‘Financial assets designated at fair value’ and ‘Financial investments’. The liabilities related to these contracts are included in ‘Financial liabilities designated at fair value’.
 - Previously all income and expenses related to the insurance business were included in ‘Other operating income’. The comparative figures disclosed in the financial statements have been reclassified to show net earned insurance premiums and net insurance claims incurred. However, in accordance with the transitional provisions of HKAS 39, the comparative figures have not been remeasured, and investment income on assets backing insurance and investment contracts in 2004 comparatives are separately analysed in Note 4d. These reclassifications have no impact on operating profit.

d HKFRS 2 – Share-based payment

HKFRS 2 requires an expense to be recognised by the group where employees are awarded options over shares in HSBC Holdings plc and where the group awards shares to employees in compensation for services rendered to the group. The group recognises an expense in all cases where equity instruments of HSBC Holdings plc are granted to employees for services rendered to the group, regardless of whether the equity instruments are granted directly by HSBC Holdings plc or by the group. The expense is recognised over the vesting period relevant to each type of award. Details of the new accounting policy are set out in Note 3s.

Prior to the adoption of HKFRS 2, share options that were awarded by HSBC Holdings plc directly to employees of the group were not recognised in the group’s financial statements. When the group awarded its employees shares of HSBC Holdings plc, the amount payable by the group to acquire the shares was recorded as an expense.

In accordance with the transitional rules of HKFRS 2, the group has applied the new accounting policy retrospectively to all share-based payment transactions where the grant date was after 7 November 2002 and which had not vested by 31 December 2004.

The change in accounting policy has resulted in share-based payment expenses being recognised in 2005 of HK\$876 million (2004: HK\$466 million). At 31 December 2005, the reserve arising from the grant of share options to the group’s employees was HK\$629 million (2004: HK\$322 million) and the liability recognised for share awards made by the group was HK\$576 million (2004: HK\$211 million).

2A Adoption of new and revised HKFRS (continued)

e HKAS 17 – Leases

HKAS 17 requires leasehold land to be classified as held under operating leases. With some exceptions, as described in Note 3o, this has resulted in the remeasurement of certain interests in land (principally held in Hong Kong) from a fair value basis to an historical cost basis. Such interests in land have been removed from ‘Property, plant and equipment’ and reclassified as ‘Other assets’. This has resulted in a decrease in assets and a decrease in previously reported revaluation reserves.

If the previous accounting policy had been applied in 2005, total assets and equity would have been increased by approximately HK\$15,684 million and HK\$12,939 million respectively at 31 December 2005 (2004: HK\$10,746 million and HK\$9,352 million respectively). Deferred tax liability would have been increased by HK\$2,745 million (2004: HK\$1,394 million). In addition, operating profit in 2005 would have been reduced by the additional depreciation charge attributable to the revaluation of approximately HK\$442 million (2004: HK\$245 million).

In the Group’s interim news release for the six months ended 30 June 2005, leases of land exceeding 500 years to expiry at inception were recognised as finance leases and were included in the balance sheet as ‘Property, plant and equipment’ at fair value less accumulated depreciation. Following the publication of a summary of a meeting of the International Financial Reporting Interpretations Committee in December 2005, at which a related issue had been discussed, the group considered it would be appropriate to classify all leases of land as operating leases, regardless of the length of the lease, unless the specific conditions described in Note 3o are met.

f HKAS 40 – Investment properties (Note 3o(iii))

HKAS 40 requires unrealised revaluation gains and losses on investment properties to be recognised directly in the income statement as they arise. Prior to the implementation of this standard, revaluation gains on investment properties were recognised in equity until the investment properties were sold, at which point the cumulative revaluation gains or losses would be included in the calculation of the gain or loss on disposal. The new policy increases operating profit for 2005 by HK\$1,167 million.

In accordance with the transitional provisions of HKAS 40, the 2004 income statement has not been restated to conform to the new accounting policy.

g HKFRS 3 – Business combinations

HKFRS 3 has been applied with effect from 1 January 2004, in accordance with the transitional provisions of the standard. The principal effect of this is that previously recognised goodwill has been frozen at its carrying value (cost less accumulated amortisation and impairment) as at 1 January 2004. Thereafter, goodwill is not amortised, but is tested annually for impairment. Prior to this change of accounting policy, goodwill was amortised over its estimated useful life.

HKFRS 3 also requires intangible assets to be recognised upon acquisition of a subsidiary or an associate. As a result of this, intangible assets have reclassified from goodwill.

No impairment losses have been recognised as a result of applying the new policy for 2004 and 2005. The comparative figures for 2004 have been restated to comply with the new policy.

The cessation of goodwill amortisation has resulted in an increase in profit before tax for 2005 of HK\$145 million (2004: HK\$43 million). The carrying amount of goodwill in the balance sheet has therefore not been reduced by the same amount.

The net effect of ceasing the amortisation of goodwill and the additional amortisation charged on intangible assets leads to a decrease in profit before tax of HK\$44 million in 2005. For 2004, the net effect was an increase in profit before tax of HK\$43 million.

h HKAS 38 – Intangible assets

The application of HKAS 38 has resulted in the recognition of internally developed software as an asset in 2005 of approximately HK\$628 million. Under the group’s previous accounting policy, software development costs were recognised as expenses as they were incurred.

The effect of the new policy is to increase operating profit for 2005 by approximately HK\$590 million, representing the capitalised internally developed software, less amortisation for the year.

Notes on the Accounts (continued)

2A Adoption of new and revised HKFRS (continued)

Consolidated Income Statement for the year ended 31 December 2004
Reconciliation of previous accounting standards and HKFRS – effect of transition to HKFRS (excluding the effect of HKAS 39)

	<i>For the year ended 31 December 2004</i>	<i>Assets acquired in exchange for advances 2004</i>	<i>Pension and other post-retirement benefits</i>	<i>Property</i>	<i>Goodwill</i>	<i>Equity compensation plans</i>	<i>Insurance contracts</i>	<i>Investment contracts reclassified</i>	<i>Preference shares</i>	<i>Consolidation and others</i>	<i>Reclassification</i>	<i>For the year ended 31 December 2004</i>
	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As reported</i>	<i>As restated</i>
Interest income	57,911	(2)	–	–	–	–	266	–	–	(228)	–	57,947
Interest expense	(19,679)	–	–	–	–	–	4	–	(1,540)	238	–	(20,977)
Net interest income	38,232	(2)	–	–	–	–	270	–	(1,540)	10	–	36,970
Fee income	19,874	–	–	–	–	–	10	–	–	(408)	–	19,476
Fee expense	(3,184)	–	–	–	–	–	(102)	–	–	91	–	(3,195)
Net fee income	16,690	–	–	–	–	–	(92)	–	–	(317)	–	16,281
Net trading income	6,615	–	–	–	–	8	15	–	–	365	–	7,003
Net investment income on assets backing policyholder liabilities	–	–	–	–	–	–	2,420	(1,522)	–	–	–	898
Gains less losses from financial investments	–	–	–	–	–	–	–	–	–	–	1,497	1,497
Dividend income	186	–	–	–	–	–	(1)	–	–	(22)	–	163
Net earned insurance premiums	–	–	–	–	–	–	18,222	(4,137)	–	–	–	14,085
Other operating income	5,930	55	–	3	–	–	(3,436)	–	–	(5)	–	4,114
Total operating income	67,653	53	–	3	–	8	17,398	(5,659)	(1,540)	31	3,064	81,011
Net insurance claims incurred and movement in policyholder liabilities	–	–	–	–	–	–	(17,384)	5,659	–	–	–	(11,725)
Net operating income before loan impairment charges and other credit risk provisions	67,653	53	–	3	–	8	14	–	(1,540)	31	3,064	69,286
Loan impairment charges and other credit risk provisions	769	(38)	–	–	–	–	–	–	–	–	131	862
Net operating income	68,422	15	–	3	–	8	14	–	(1,540)	31	3,195	70,148
Employee compensation and benefits	(14,743)	–	33	–	–	(95)	8	–	–	32	–	(14,765)
General and administrative expenses	(10,079)	–	–	(56)	–	–	(22)	–	–	(5)	(131)	(10,293)
Depreciation of property, plant and equipment	(2,096)	–	–	245	–	–	–	–	–	99	–	(1,752)
Amortisation of intangible assets	(74)	–	–	–	73	–	–	–	–	(100)	–	(101)
Total operating expenses	(26,992)	–	33	189	73	(95)	(14)	–	–	26	(131)	(26,911)
Operating profit	41,430	15	33	192	73	(87)	–	–	(1,540)	57	3,064	43,237
Profit on tangible fixed assets and long-term investments	2,098	(16)	–	–	(62)	–	–	–	–	10	(2,030)	–
Surplus arising on property revaluation	1,024	–	–	10	–	–	–	–	–	–	(1,034)	–
Share of profit in associates	414	–	–	–	32	–	–	–	–	(3)	(144)	299
Profit before tax	44,966	(1)	33	202	43	(87)	–	–	(1,540)	64	(144)	43,536
Tax expense	(7,086)	–	(16)	(33)	43	(24)	–	–	–	27	144	(6,988)
Profit after tax	37,880	(1)	17	169	43	(111)	–	–	(1,540)	91	–	36,548
Minority interests	(4,315)	–	–	–	–	18	–	–	–	(103)	–	(4,400)
Profit attributable to shareholders	33,565	(1)	17	169	43	(93)	–	–	(1,540)	(12)	–	32,148

2A Adoption of new and revised HKFRS (continued)

Consolidated Balance Sheet at 31 December 2004
Reconciliation of previous accounting standards and HKFRS – effect of transition to HKFRS (excluding the effect of HKAS 39)

<i>Figures in HK\$m</i>	<i>At 31 December 2004</i>		<i>Assets acquired in exchange for advances</i>	<i>Pension and other post-retirement benefits</i>	<i>Property</i>	<i>Goodwill</i>	<i>Equity compensation plans</i>	<i>Insurance contracts</i>	<i>Investment contracts reclassified</i>	<i>Netting</i>	<i>Preference shares</i>	<i>Consolidation and others</i>	<i>At</i>
	<i>As reported</i>	<i>As restated</i>											<i>31 December 2004</i>
ASSETS	501,207							5,098		4,287		52	510,644
Cash and short-term funds													
Placings with banks maturing after one month	74,481							230					74,711
Items in the course of collection from other banks	13,479												13,479
Certificates of deposit	48,643							3,100					51,743
Hong Kong SAR Government certificates of indebtedness	92,334												92,334
Trading assets	85,356							(7,230)		8,330		1,276	87,732
Derivatives	54,837									39,541		20	94,398
Advances to customers	919,253	(561)										500	919,192
Financial investments	425,635							45,996				135	472,332
Amounts due from fellow subsidiary companies	82,592							6,330				(6,330)	82,592
Investments in associates	16,918					32						(500)	16,343
Goodwill and intangible assets	1,526					67		3,513				223	5,329
Property, plant and equipment	42,080											(223)	27,204
Deferred tax assets	1,659											52	1,711
Retirement benefit assets	1,297			10									1,307
Other assets	97,748	561			4,014	24	(83)	(66,259)		(1)		(240)	35,764
	2,459,045			10	(10,746)	123	483	(9,222)		52,157		(5,035)	2,486,815

Notes on the Accounts (continued)

2A Adoption of new and revised HKFRS (continued)

	At 31 December 2004 As reported	Assets acquired in exchange for advances	Pension and other retirement benefits	Property	Goodwill	Equity compensation plans	Insurance contracts reclassified	Investment contracts	Netting	Preference shares	Consolidation and others	At 31 December 2004 As restated
LIABILITIES												
Hong Kong SAR currency notes in circulation	92,334	-	-	-	-	-	-	-	-	-	-	92,334
Deposits by banks	73,098	-	-	-	-	-	2	-	1,880	-	-	74,980
Customer accounts	1,730,494	-	-	-	-	-	(227)	-	221	-	(2,377)	1,728,111
Items in the course of transmission to other banks	23,452	-	-	-	-	-	-	-	-	-	-	23,452
Trading liabilities	37,281	-	-	-	-	-	-	-	-	-	-	37,281
Derivatives	50,635	-	-	-	-	-	-	-	41,727	-	-	92,362
Debt securities in issue	150,179	-	-	-	-	-	(55)	-	8,315	-	(3,277)	155,162
Retirement benefit liabilities	211	-	116	-	-	-	-	-	-	-	-	327
Amounts due to fellow subsidiary companies	17,137	-	-	-	-	-	219	-	-	432	(220)	17,568
Amounts due to ultimate holding company	479	-	-	-	-	-	-	-	-	74	-	553
Other liabilities	39,096	-	-	-	(121)	(46)	(54)	-	14	(506)	(1,225)	37,158
Liabilities to policyholders under long-term assurance business	62,643	-	-	-	-	-	(9,107)	(54,938)	-	-	1,402	-
Liabilities to customers under investment contracts	-	-	-	-	-	-	-	28,516	-	-	-	28,516
Liabilities to customers under insurance contracts issued	-	-	-	-	-	-	-	26,422	-	-	-	26,422
Current taxation	2,333	-	-	-	-	-	-	-	-	-	-	2,333
Deferred taxation	4,676	-	(23)	(1,394)	50	88	-	-	-	-	(2)	3,395
Subordinated liabilities	11,142	-	-	-	-	-	-	-	-	-	-	11,142
Preference shares	-	-	-	-	-	-	-	-	-	55,602	-	55,602
	2,295,190	-	93	(1,394)	(71)	42	(9,222)	-	52,157	55,602	(5,699)	2,386,698
	74,213	-	-	-	-	-	-	-	-	(51,719)	-	22,494
Share capital	17,399	-	-	(10,594)	-	332	-	-	-	(3,883)	2,775	6,029
Other reserves	51,083	-	(83)	1,242	194	109	-	-	-	-	(2,061)	50,484
Retained profits	4,800	-	-	-	-	-	-	-	-	-	-	4,800
Proposed final interim dividend	147,495	-	-	-	-	-	-	-	-	-	-	147,495
Shareholders' funds	16,360	-	-	-	-	-	-	-	-	-	(50)	16,310
Minority interests	163,855	-	-	-	-	-	-	-	-	-	-	163,855
	2,459,045	-	10	(10,746)	123	483	(9,222)	-	52,157	-	(5,035)	2,486,815

2A Adoption of new and revised HKFRS (continued)

Balance Sheet at 31 December 2004

Reconciliation of previous accounting standards and HKFRS – effect of transition to HKFRS (excluding the effect of HKAS 39)

Figures in HK\$m	At 31 December 2004		Assets acquired in exchange for advances	Pension and other post-retirement benefits	Property	Goodwill	Equity compensation plans	Netting	Preference shares	Change in accounting policy (Note 3m)	Consolidation and others	At
	As reported	As restated										
ASSETS	430,296	434,583										
Cash and short-term funds												
Placings with banks maturing after one month	56,543	56,543										
Items in the course of collection from other banks	9,007	9,007										
Certificates of deposit	12,441	12,441										
Hong Kong SAR Government certificates of indebtedness	92,334	92,334										
Trading assets	75,393	83,723					8,330					
Derivatives	52,531	92,092					39,541				20	
Advances to customers	597,910	597,674	(236)									
Financial investments	272,833	273,549				537					179	
Amounts due from subsidiary companies	19,062	19,062										
Amounts due from fellow subsidiary companies	79,721	79,721										
Investments in subsidiaries	142,138	142,138								(138,070)		
Investments in associates	14,076	13,864								(160)		
Goodwill and intangible assets	895	1,114										
Property, plant and equipment	21,924	15,288										
Deferred tax assets	1,069	1,120										
Retirement benefit assets	967	1,026		59								
Other assets	25,732	28,179	236			(75)		(1)			(244)	
	1,904,872	1,815,440		59	(3,899)	13	462	52,157		(138,230)	6	

Notes on the Accounts (continued)

2A Adoption of new and revised HKFRS (continued)

Figures in HK\$m	At 31 December 2004		Assets acquired in exchange for advances	Pension and other post-retirement benefits	Property	Goodwill	Equity compensation plans	Netting	Preference shares	Change in accounting policy (Note 3m)	Consolidation and others	At
	As reported	As restated										
LIABILITIES												
Hong Kong SAR currency notes in circulation	92,334	92,334	-	-	-	-	-	-	-	-	-	92,334
Deposits by banks	64,317	66,197	-	-	-	1,880	-	-	-	-	-	66,197
Customer accounts	1,228,674	1,228,680	-	-	-	221	-	-	-	-	(215)	1,228,680
Items in the course of transmission to other banks	17,234	17,234	-	-	-	-	-	-	-	-	-	17,234
Trading liabilities	31,439	31,439	-	-	-	-	-	-	-	-	-	31,439
Derivatives	48,752	48,752	-	-	-	41,727	-	-	-	-	-	90,479
Debt securities in issue	100,160	108,413	-	-	-	8,315	-	-	-	-	(62)	108,413
Retirement benefit liabilities	200	320	-	120	-	-	-	-	-	-	-	320
Amounts due to subsidiary companies	13,368	13,583	-	-	-	-	-	-	-	-	215	13,583
Amounts due to fellow subsidiary companies	15,510	15,941	-	-	-	-	-	432	-	-	(1)	15,941
Amounts due to ultimate holding company	451	525	-	-	-	-	-	74	-	-	-	525
Other liabilities	30,116	29,735	-	(93)	-	14	55	(506)	-	-	149	29,735
Current taxation	1,708	1,706	-	-	-	-	-	-	-	-	(2)	1,706
Deferred taxation	1,955	1,405	-	82	(681)	48	-	-	-	-	1	1,405
Subordinated liabilities	9,686	9,686	-	-	-	-	-	-	-	-	-	9,686
Preference shares	-	55,602	-	-	-	-	-	55,602	-	-	-	55,602
	<u>1,655,904</u>	<u>1,763,279</u>	-	109	(681)	48	55	52,157	55,602	-	85	<u>1,763,279</u>
EQUITY												
Share capital	74,213	22,494	-	-	-	-	-	-	(51,719)	-	-	22,494
Other reserves	135,710	1,741	-	-	(1,823)	-	244	-	(3,883)	(129,430)	923	1,741
Retained profits	34,245	23,126	-	(50)	(1,395)	(35)	163	-	-	(8,800)	(1,002)	23,126
Proposed final interim dividend	4,800	4,800	-	-	-	-	-	-	-	-	-	4,800
Shareholders' funds	<u>248,968</u>	<u>52,161</u>	-	-	-	-	-	-	-	-	-	<u>52,161</u>
	<u>1,904,872</u>	<u>1,815,440</u>	-	59	(3,899)	13	462	52,157	-	(138,230)	6	<u>1,815,440</u>

2A Adoption of new and revised HKFRS (continued)

Consolidated Balance Sheet at 1 January 2005
Effect of transition impacted by HKAS 39

<i>Figures in HK\$m</i>	<i>Balance excluding HKAS 39</i>	<i>HKAS 39</i>	<i>Balance including HKAS 39</i>
ASSETS			
Cash and short-term funds	510,644	(33,625)	477,019
Placings with banks maturing after one month	74,711	(1,018)	73,693
Items in the course of collection from other banks	13,479	–	13,479
Certificates of deposit	51,743	(2)	51,741
Hong Kong SAR Government certificates of indebtedness	92,334	–	92,334
Trading assets	87,732	42,208	129,940
Financial assets designated at fair value	–	36,072	36,072
Derivatives	94,398	(7,237)	87,161
Advances to customers	919,192	(4,036)	915,156
Financial investments	472,332	(37,635)	434,697
Amounts due from fellow subsidiary companies	82,592	(1,477)	81,115
Investments in associates	16,343	–	16,343
Goodwill and intangible assets	5,329	–	5,329
Property, plant and equipment	27,204	–	27,204
Deferred tax assets	1,711	(328)	1,383
Retirement benefit assets	1,307	–	1,307
Other assets	35,764	12,241	48,005
Total assets	2,486,815	5,163	2,491,978
LIABILITIES			
Hong Kong SAR currency notes in circulation	92,334	–	92,334
Deposits by banks	74,980	(2,325)	72,655
Customer accounts	1,728,111	(34,994)	1,693,117
Items in the course of transmission to other banks	23,452	–	23,452
Financial liabilities designated at fair value	–	1,254	1,254
Trading liabilities	37,281	125,743	163,024
Derivatives	92,362	654	93,016
Debt securities in issue	155,162	(91,473)	63,689
Retirement benefit liabilities	327	–	327
Amounts due to fellow subsidiary companies	17,568	(1,731)	15,837
Amounts due to ultimate holding company	553	–	553
Other liabilities	37,158	6,445	43,603
Liabilities to customers under investment contracts	28,516	–	28,516
Liabilities under insurance contracts issued	26,422	–	26,422
Current taxation	2,333	29	2,362
Deferred taxation	3,395	(155)	3,240
Subordinated liabilities	11,142	74	11,216
Preference shares	55,602	–	55,602
Total liabilities	2,386,698	3,521	2,390,219
EQUITY			
Share capital	22,494	–	22,494
Other reserves	6,029	1,333	7,362
Retained profits	50,484	(39)	50,445
Proposed final interim dividend	4,800	–	4,800
Shareholders' funds	83,807	–	85,101
Minority interests	16,310	348	16,658
	100,117	–	101,759
	2,486,815	5,163	2,491,978

Notes on the Accounts (continued)**2A Adoption of new and revised HKFRS** (continued)

Balance Sheet at 1 January 2005
Effect of transition impacted by HKAS 39

<i>Figures in HK\$m</i>	<i>Balance excluding HKAS 39</i>	<i>HKAS 39</i>	<i>Balance including HKAS 39</i>
ASSETS			
Cash and short-term funds	434,583	(29,063)	405,520
Placings with banks maturing after one month	56,543	(419)	56,124
Items in the course of collection from other banks	9,007	–	9,007
Certificates of deposit	12,441	(6,014)	6,427
Hong Kong SAR Government certificates of indebtedness	92,334	–	92,334
Trading assets	83,723	25,916	109,639
Financial assets designated at fair value	–	10,216	10,216
Derivatives	92,092	(7,499)	84,593
Advances to customers	597,674	(4,706)	592,968
Financial investments	273,549	4,411	277,960
Amounts due from subsidiary companies	19,062	–	19,062
Amounts due from fellow subsidiary companies	79,721	(1,478)	78,243
Investments in subsidiary companies	4,120	–	4,120
Investments in associates	13,864	–	13,864
Goodwill and intangible assets	1,114	–	1,114
Property, plant and equipment	15,288	–	15,288
Deferred tax assets	1,120	(237)	883
Retirement benefit assets	1,026	–	1,026
Other assets	28,179	9,756	37,935
Total assets	1,815,440	883	1,816,323
LIABILITIES			
Hong Kong SAR currency notes in circulation	92,334	–	92,334
Deposits by banks	66,197	(2,309)	63,888
Customer accounts	1,228,680	(27,717)	1,200,963
Items in the course of transmission to other banks	17,234	–	17,234
Trading liabilities	31,439	117,053	148,492
Financial liabilities designated at fair value	–	1,252	1,252
Derivatives	90,479	(432)	90,047
Debt securities in issue	108,413	(89,574)	18,839
Retirement benefit liabilities	320	–	320
Amounts due to subsidiary companies	13,583	–	13,583
Amounts due to fellow subsidiary companies	15,941	(1,731)	14,210
Amounts due to ultimate holding company	525	–	525
Other liabilities	29,735	4,737	34,472
Current taxation	1,706	(30)	1,676
Deferred taxation	1,405	(412)	993
Subordinated liabilities	9,686	74	9,760
Preference shares	55,602	–	55,602
Total liabilities	1,763,279	911	1,764,190
EQUITY			
Share capital	22,494	–	22,494
Other reserves	1,741	915	2,656
Retained profits	23,126	(943)	22,183
Proposed final interim dividend	4,800	–	4,800
Shareholders' funds	52,161	–	52,133
	1,815,440	883	1,816,323

2B Critical accounting estimates and judgments in applying accounting policies

The preparation of financial statements requires the group to make certain estimates and to form judgments about the application of its accounting policies. The most significant areas where estimates and judgments have been made are set out below.

Fair value estimation

As disclosed in note 3, a significant proportion of the group's financial assets and liabilities are stated in the balance sheet at fair value. Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Where there is an active market for financial assets and liabilities and quoted prices are available, then such prices are the best indicator of fair value. In the normal course of business, however, the group also holds financial assets and liabilities, including certain non-exchange traded derivatives, where quoted prices in an active market are not available. As disclosed elsewhere in the financial statements, the group uses valuation techniques to determine the fair value of such financial instruments. The valuation techniques used for different financial instruments are selected to reflect how the market would be expected to price the instruments, using inputs that reasonably reflect the risk-return factors inherent in the instruments. Depending upon the characteristics of the financial instruments concerned, observable market factors are available for use in most valuations, while others involve a greater degree of judgment and estimation.

In the case of trading assets and liabilities, derivatives, and financial assets and liabilities designated at fair value, the estimation of fair value at the reporting date affects profit for the year. The group has, and maintains, a substantial pool of expertise in the valuation of financial instruments and valuation estimates are benchmarked against actual outcomes, where practicable, to ensure that the valuation techniques reflect actual market activity.

Accounting standards also require disclosure of the estimated fair value of certain financial instruments that are stated in the balance sheet at amortised cost. These disclosures, which are made in the notes on the financial statements, affect neither the profit for the year nor the carrying amounts of any assets or liabilities in the balance sheet. The estimation of fair value of some of these classes of assets and liabilities is performed in the absence of active markets for instruments with similar characteristics. The amounts disclosed, therefore, may involve a higher degree of judgment and estimation than is the case for most of the assets and liabilities which are carried at fair value on the balance sheet. For example, the fair value of advances to customers as disclosed in Note 15a generally used the following estimation methods and assumptions:

- for advances maturing within one year, the fair value is generally assumed to be the same as the book value unless there is reason to believe that the credit spread has changed;
- for advances maturing or repricing after one year, the fair value is estimated on repricing at the current interest rate; and in addition,
- for large corporate facilities, fair value is estimated by reference to the credit spread that would currently apply to a new loan on similar terms.

Loan impairment

Application of the group's methodology for assessing loan impairment, as set out in Note 3d, involves considerable judgment and estimation.

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

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

Notes on the Accounts (continued)

2B Critical accounting estimates and judgments in applying accounting policies (continued)

Special purpose entities

In the normal course of business, the group participates, in a variety of ways, in financial structures involving special purpose entities. Judgment is required in determining whether the rights and obligations taken on result in the group having control of the special purpose entity and whether it should be included in the consolidated financial statements as a subsidiary.

Impairment of available-for-sale financial investments

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

Liabilities under investment contracts

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

Insurance contracts

Classification

HKFRS 4 and HKAS 39 require the group to determine whether an insurance contract that transfers both insurance risk and financial risk is classified as an insurance contract under HKFRS 4, or as a financial instrument, or whether the insurance and non-insurance elements of the contract should be accounted for separately. This process involves judgment and estimation of the amounts of different types of risks that are transferred or assumed under a contract. The estimation of such risks often involves the use of assumptions about future events and is thus subject to a degree of uncertainty.

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

The value of PVIF, which is recorded as an intangible asset, depends upon assumptions regarding future events. These are described in more detail in Note 20b. The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

Insurance liabilities

The estimation of insurance claims liabilities involves selecting statistical models and making assumptions about future events which need to be frequently calibrated against experience and forecasts. The sensitivity of insurance liabilities to potential changes in key assumptions is set out in Note 30a.

Income taxes

The group is subject to income taxes in many jurisdictions and significant judgment is required in estimating the group's provision for income taxes. There are many transactions and interpretations of tax law for which the final outcome will not be established until some time later. The group recognises liabilities for taxation based on estimates of whether additional taxes will be payable. The estimation process includes seeking expert advice where appropriate.

Where the final liability for taxation is different from the amounts that were initially recorded, these differences will affect the income tax and deferred tax provisions in the period in which the estimate is revised or the final liability is established.

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

Held-to-maturity securities

As indicated in Note 3g, certain debt instruments within the 'Financial investments' category are classified as held-to-maturity investments. In order to be able to use this classification, the group needs to exercise judgment upon initial recognition of the investments as to whether it has the positive intention and ability to hold them until maturity. A failure to hold these investments to maturity, in all but a limited number of circumstances, would result in the entire held-to-maturity category being reclassified as 'available-for-sale'. They would then be measured at fair value. The carrying amount and the fair value of held-to-maturity securities at 31 December 2005 are disclosed in Note 10 and 17a on the accounts.

2C Accounting standards issued but not yet effective

The HKICPA has issued the following standards and interpretations which are not yet effective but which will be relevant to the group. These standards have not been adopted early.

- HKFRS 7 - Financial Instruments: Disclosures
- Amendment to HKAS 1 - Capital disclosures
- Amendments, as a consequence of the Hong Kong Companies (Amendment) Ordinance 2005, to:
 - HKAS 1 - Presentation of Financial Statements
 - HKAS 27 - Consolidated and Separate Financial Statements
 - HKFRS 3 - Business Combinations

The Hong Kong Companies (Amendment) Ordinance 2005 came into effect on 1 December 2005 and will be applicable to the group's financial statements in 2006. Amongst other things, this will broaden the definition of a subsidiary under the Hong Kong Companies Ordinance so as to remove inconsistencies with the definition of subsidiary contained in HKAS 27.

The group is in the process of assessing the impact of these new and revised standards on its 2006 financial statements. To date, its preliminary conclusions are that:

- HKFRS 7 will result in more extensive disclosures regarding financial instruments, but will not affect reported profit or the amounts of assets and liabilities recognised in the balance sheet;
- the amendment to HKAS 1 - Capital disclosures will result in the group disclosing further detail about how it manages its capital resources; and
- the amendments to HKAS 1, HKAS 27 and HKFRS 3 and the Hong Kong Companies Ordinance are not expected to materially affect the amounts reported in 2005.

3 Principal accounting policies

a Interest income and expense

From 1 January 2005

Interest income and expense for all interest-bearing financial instruments except those classified as held for trading or designated at fair value are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest rates of the financial assets or financial liabilities to which they relate.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts.

Notes on the Accounts (continued)**3 Principal accounting policies** (continued)

Interest on impaired financial assets is recognised at the original effective interest rate of the financial asset applied to the impaired carrying amount. The accounting policy for recognising impairment of loans and advances is set out in Note 3d below.

From 1 January 2004 to 31 December 2004

Interest income was recognised in the income statement as it accrued, except in the case of impaired loans and advances. Interest on impaired loans was not recognised in the income statement, but was credited to an interest suspense account in the balance sheet which was netted against the relevant loan.

b Non interest income*(i) Fee income****From 1 January 2005***

The group earns fee income from a diverse range of services it provides to its customers. Fee income is accounted for as follows:

- if the income is earned on the execution of a significant act, it is recognised as revenue when the significant act has been completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- if the income is earned as services are provided, it is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- if the income is an integral part of the effective interest rate of a financial instrument, it is recognised as an adjustment to the effective interest rate (for example, loan commitment fees) and recorded in 'Interest income' (see Note 3a).

From 1 January 2004 to 31 December 2004

Fee income was accounted for as follows:

- income earned on the execution of a significant act, and income earned as services were provided were recognised as revenue on the same basis as described above for 2005; or
- if the income was clearly interest in nature, it was recognised on an appropriate basis over the relevant period and recorded in 'Interest income' (see Note 3a).

(ii) Dividend income

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

*(iii) Net income from financial instruments designated at fair value****From 1 January 2005***

Net income from financial instruments designated at fair value comprises all gains and losses from changes in the fair value (net of accrued coupon) of such financial assets and financial liabilities, together with interest income and expense and dividend income attributable to those financial instruments.

There was no such category for financial instruments prior to 1 January 2005.

3 Principal accounting policies (continued)

(iv) Net trading income

From 1 January 2005

Net trading income comprises interest income and expense and dividend income attributable to trading financial assets and liabilities, together with all gains and losses from changes in fair value. Income and expenses arising from economic hedging activities which do not qualify for hedge accounting under HKAS 39, as well as from the ineffective portion of qualifying hedges, are also included in 'Net trading income'.

From 1 January 2004 to 31 December 2004

Net trading income comprised all gains and losses from changes in fair value (net of accrued coupons) of trading financial assets and financial liabilities. Interest income and expense, and dividend income were recognised in 'Net interest income' or 'Dividend income' as appropriate.

c Advances to customers and placings with banks

From 1 January 2005

Advances to customers and placings with banks are loans and advances originated by the group, which have not been classified as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are initially recorded at fair value plus any transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses.

Loans and advances classified as held for trading or designated at fair value are reported as trading instruments, or financial instruments designated at fair value, respectively (Note 3e and 3f).

From 1 January 2004 to 31 December 2004

Advances to customers and placings with banks included loans and advances originated by the group, which were not intended to be sold in the short term and had not been classified as held for trading. Loans and advances were recognised when cash was advanced to borrowers. They were measured at cost plus or minus amortisation of discounts or premiums as appropriate less provisions for impaired loans and advances.

d Loan impairment

From 1 January 2005

It is the group's policy to make provisions for impaired loans and advances promptly where there is objective evidence that impairment of a loan or portfolio of loans has occurred.

Impairment losses are assessed for all credit exposures. Loans that are individually significant are assessed and where impairment is identified, impairment losses are recognised. Loans that have been subject to individual assessment, but for which no impairment has been identified are then assessed collectively to estimate the amount of impairment at the reporting date, which has not been specifically identified. Loans which are not individually significant, but which can be aggregated into groups of exposures sharing similar characteristics, are then assessed collectively to identify and calculate impairment losses which have occurred by the reporting date. This methodology is explained in greater detail below.

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

Impairment losses are only recognised when there is evidence that they have been incurred prior to the reporting date. Losses which may be expected as a result of future events, no matter how likely, are not recognised.

(i) Individually significant loans

Impairment losses on individually significant accounts are assessed by an evaluation of the exposures on a case-by-case basis. The group assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining the impairment losses on individually assessed accounts, the following factors are considered:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and capability to trade successfully out of financial difficulties and generate sufficient cash flow to service their debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain and make payments in the relevant foreign currency if loans are not in local currency; and
- where available, the secondary market price for the debt.

The impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged to the income statement. The carrying amount of impaired loans is reduced through the use of an allowance account.

(ii) Collectively assessed loans

Impairment losses are calculated on a collective basis in two different scenarios:

- in respect of losses which have been incurred but have not yet been identified on loans subject to individual assessment for impairment (see section (i) above); and
- for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. The loss calculated by this method represents impairments that have occurred at the balance sheet date but which will not be individually identified as such until some time in the future.

3 Principal accounting policies *(continued)*

The collective impairment loss is determined after taking into account:

- historical loss experience in portfolios of similar risk characteristics (for example, by industry and geographical sectors, loan grade or product);
- the estimated period between a loss occurring and the establishment of an allowance against the loss on an individual loan; and
- management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined by management for each identified portfolio.

Homogeneous groups of loans

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis.

- When appropriate empirical information is available, the group utilises roll rate methodology. This methodology utilises a statistical analysis of historical trends of the probability of default and amount of consequential loss, assessed for each time period during which the customer's contractual payments are overdue. The amount of loss is based on the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio. Other historical data and an evaluation of current economic conditions are also considered to calculate the appropriate level of impairment allowance based on inherent loss.
- In other cases, when the portfolio size is small or when information is insufficient or not sufficiently reliable to adopt a roll rate methodology, the group adopts a formulaic approach which allocates loss rates having regard to the period of time for which a customer's loan is overdue. Loss rates are based on the discounted expected future cash flows from a portfolio.
- Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

(iii) Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been estimated.

(iv) Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reduced accordingly. The reduction of an impairment loss under these circumstances is recognised in the income statement in the period in which it occurs.

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

(v) Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included within 'Other operating income' in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised as a gain in 'Other operating income' in the income statement.

Debt securities or equities acquired in debt-to-debt/equity swaps are included in 'Financial investments' and are classified as available-for-sale.

(vi) Renegotiated loans

Loans that have been individually identified as impaired and whose terms have been subsequently renegotiated and which have been performing satisfactorily for a certain period are no longer treated as impaired.

From 1 January 2004 to 31 December 2004

Loans were designated as non-performing as soon as management had doubts as to the ultimate collectibility of principal or interest or when contractual payments of principal or interest were 90 days overdue. When a loan was designated as non-performing, interest was suspended (see below) and a specific provision raised if required.

However, the suspension of interest could be exceptionally deferred for up to 12 months in the following situations:

- where cash collateral was held covering the total of principal and interest due and a legal right of set-off existed; or
- where the value of net realisable tangible security was considered more than sufficient to cover the full repayment of all principal and interest due and credit approval had been given to the rolling-up or capitalisation of interest payments.

There were two basic types of provision, specific and general.

Specific provisions

Specific provisions represented the quantification of actual and expected losses from identified accounts and were deducted from loans and advances in the balance sheet.

Other than where provisions on smaller balance homogenous loans were assessed on a portfolio basis, the amount of specific provision raised was assessed on a case-by-case basis. The amount of specific provision raised was the group's conservative estimate of the amount needed to reduce the carrying value of the asset to the expected ultimate net realisable value, and in reaching a decision consideration was given, among other things, to the following factors:

- the financial standing of the customer, including a realistic assessment of the likelihood of repayment of the loan within an acceptable period and the extent of the group's other commitments to the same customer;
- the realisable value of any security for the loan;
- the costs associated with obtaining repayment and realisation of the security;
- if loans were not in the local currency, the ability of the borrower to obtain the relevant foreign currency; and
- the expected timeframe over which repayment would be made.

3 Principal accounting policies (continued)

Where specific provisions were raised on a portfolio basis, the level of provisioning took into account management's assessment of the portfolio's structure, past and expected credit losses, business and economic conditions, and any other relevant factors. The principal portfolios evaluated on this basis are credit cards and other consumer lending products.

General provisions

General provisions augmented specific provisions and provided cover for loans which were impaired at the balance sheet date but which would not be identified as such until some time in the future. The group maintained a general provision which was determined by taking into account the structure and risk characteristics of the loan portfolio. Historical levels of latent risk were regularly reviewed to determine that the level of general provisioning continued to be appropriate. Where entities of the group operated in a significantly higher risk environment, an increased level of general provisioning was applied taking into account local market conditions and economic and political factors. General provisions were deducted from loans and advances to customers in the balance sheet.

Loans on which interest was being suspended

Provided that there was a realistic prospect of interest being paid at some future date, interest on non-performing loans was charged to the customer's account. However, the interest was not credited to the income statement but to an interest suspense account in the balance sheet which was netted against the relevant loan. On receipt of cash (other than from the realisation of security), suspended interest was recovered and taken to the income statement. Amounts received from the realisation of security were applied to the repayment of outstanding indebtedness, with any surplus used to release any specific provisions and then suspended interest.

Non-accrual loans

Where the probability of receiving interest payments was remote, interest was no longer accrued and any suspended interest balance was written off.

Loans were not reclassified as accruing until interest and principal payments were up-to-date and future payments were reasonably assured.

Loans and suspended interest were written off, either partially or in full, when there was no prospect of recovery of these amounts.

Assets acquired in exchange for advances in order to achieve an orderly realisation continued to be reported as advances. The asset acquired was recorded at the carrying value of the advance disposed of at the date of the exchange, and provisions were based on any subsequent deterioration in its value.

e *Trading assets and trading liabilities*

From 1 January 2005

Treasury bills, debt securities, structured deposits, equity shares, own debt issued and short positions in securities which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking are classified as held for trading. Such financial assets or financial liabilities are recognised initially at fair value, with transaction costs taken to the income statement, and are subsequently remeasured at fair value. All subsequent gains and losses from changes in the fair value of these assets and liabilities, together with related interest income and expense and dividends, are recognised in the income statement within 'Net trading income' as they arise. Financial assets and financial liabilities are recognised using trade date accounting.

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

From 1 January 2004 to 31 December 2004

Treasury bills, debt securities, equity shares and short positions in securities held for dealing purposes were included respectively in 'Cash and short-term funds', 'Trading assets' or 'Trading liabilities' in the balance sheet at market value. Changes in the clean market value of such assets and liabilities were recognised in the income statement as 'Net trading income' as they arose. Related interest income and expense and dividends were recognised in 'Net interest income' and 'Dividend income' respectively.

f *Financial instruments designated at fair value*

From 1 January 2005

A financial instrument, other than one held for trading, is classified in this category if it meets the criteria set out below, and is so designated by management.

Financial assets and financial liabilities so designated are recognised initially at fair value, with transaction costs taken directly to the income statement, and are subsequently remeasured at fair value. This designation, once made, is irrevocable in respect of the financial instruments to which it is made. Financial assets and financial liabilities are recognised using trade date accounting.

Gains and losses from changes in the fair value of such assets and liabilities are recognised in the income statement as they arise, together with related interest income and expense and dividends, within 'Net income from financial instruments designated at fair value'.

Gains and losses arising from the changes in fair value of derivatives that are managed in conjunction with financial assets or financial liabilities designated at fair value are included in 'Net income from financial instruments designated at fair value'.

Where issued debt has been designated at fair value and there is a related derivative, then the interest components of the debt and the derivative are recognised in 'Interest expense'.

The group may designate financial instruments at fair value where the designation:

- eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring financial assets or financial liabilities or recognising the gains and losses on them on different bases; examples include unit-linked investment contracts, financial assets held to back certain insurance contracts, and certain portfolios of securities and debt issuances that are managed in conjunction with financial assets or liabilities measured on a fair value basis; or
- applies to a group of financial assets, financial liabilities, or both, that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to key management personnel; examples include financial assets held to back certain insurance contracts, and certain asset-backed securities; or
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, and which would otherwise be required to be accounted for separately; examples include certain debt issuances and debt securities held.

From 1 January 2004 to 31 December 2004

The category, 'Financial instruments designated at fair value' was introduced on 1 January 2005 in accordance with HKAS 39.

3 Principal accounting policies (continued)

g Financial investments

From 1 January 2005

Available-for-sale securities

Treasury bills, debt securities and equity shares intended to be held on a continuing basis are classified as available-for-sale securities unless they have been designated at fair value (see Note 3f) or they are classified as held-to-maturity (see below). Available-for-sale securities are initially measured at fair value (which is usually the same as the consideration paid) plus direct and incremental transaction costs. They are subsequently remeasured at fair value.

Changes in fair value are recognised in equity until the securities are either sold or impaired. On the sale of available-for-sale securities, cumulative gains or losses previously recognised in equity are recognised through the income statement and classified as 'Gains less losses from financial investments'.

An assessment is made at each balance sheet date as to whether there is any objective evidence of impairment, being circumstances where an adverse impact on estimated future cash flows of the financial asset or group of assets can be reliably estimated.

If an available-for-sale security is determined to be impaired, the cumulative loss (measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in the income statement) is removed from equity and recognised in the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement. Impairment losses on equity instruments previously recognised in the income statement that are no longer required are reversed through reserves, not through the income statement.

Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group has the positive intention and ability to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

On 1 January 2005, the group has re-designated certain debt securities previously described as 'Long-term held-to-maturity investments' as 'Available-for-sale securities' following the implementation of HKAS 39.

Financial investments are recognised using trade date accounting.

From 1 January 2004 to 31 December 2004

Treasury bills and debt securities and equity shares were accounted for in accordance with HK SSAP 24.

Treasury bills and debt securities intended to be held on a continuing basis were classified as 'Financial investments' and included in the balance sheet at cost, adjusted for amortisation of premium and discount on acquisition less provision for permanent diminution in value. Any gain or loss on realisation of these securities was recognised in the income statement as it arose and included in 'Gains less losses from financial investments'.

Equity shares intended to be held on a continuing basis were classified as 'Financial investments' and included in the balance sheet at fair value. Gains and losses arising from changes in fair value were accounted for as movements in the 'Long-term equity investment revaluation reserve'. When an investment was disposed of, the cumulative profit or loss, including any amounts previously recognised in the long-term equity investment revaluation reserve, was included in the income statement for the year in 'Gains less losses from financial investments'.

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

h Determination of fair value

For trading instruments, available-for-sale securities and financial instruments designated at fair value that are quoted in active markets, fair values are determined by reference to the current quoted bid/offer price. Where independent prices are not available, fair values may be determined using valuation techniques with reference to observable market data. These include comparison to similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

The use of a valuation technique takes account of a number of factors as appropriate. These factors include adjustments for bid-offer spread, credit factors, and servicing costs of portfolios.

i Sale and repurchase agreements (including stock lending and borrowing)

Where securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Conversely, securities purchased under commitments to sell ('reverse repos') are not recognised on the balance sheet and the consideration paid is recorded in 'Cash and short-term funds', 'Placings with banks maturing after one month,' or 'Advances to customers' as appropriate.

The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

Securities lending and borrowing transactions are generally entered into on a collateralised basis, with securities or cash advanced or received as collateral. The transfer of the securities to counterparties is not normally reflected on the balance sheet. If cash collateral is advanced or received, an asset or liability is recorded at the amount of cash collateral advanced or received.

Securities borrowed are not recognised on the balance sheet, unless they are sold to third parties, in which case the obligation to return the securities is recorded as a trading liability and measured at fair value and any gains or losses are included in 'Net trading income'.

j Derivative financial instruments and hedge accounting

From 1 January 2005

Derivatives are initially recognised at fair value from the date a derivative contract is entered into and are subsequently re-measured at their fair value at each reporting date.

Fair values are obtained from quoted market prices in active markets, or by using valuation techniques, including recent market transactions, where an active market does not exist. Valuation techniques include discounted cash flow models and option pricing models as appropriate. All derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative.

In the normal course of business, the fair value of a derivative on initial recognition is considered to be the transaction price (i.e. the fair value of the consideration given or received). However, in certain circumstances the fair value of an instrument will be evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets, including interest rate yield curves, option volatilities and currency rates. When such evidence exists and results in a value which is different from the transaction price, the group recognises a trading profit or loss on inception of the derivative. If observable market data are not available, the initial change in fair value indicated by the valuation model, but based on unobservable inputs, is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or recognised in the income statement when the inputs become observable, or when the transaction matures or is closed out.

3 Principal accounting policies (continued)

Certain derivatives embedded in other financial instruments, such as the conversion option in a convertible bond, are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract, the terms of the embedded derivative are the same as those of a stand-alone derivative, and the combined contract is not designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists, and the cash flows are intended to be settled on a net basis.

The method of recognising the resulting fair value gains or losses depends on whether the derivative is held for trading, or is designated as a hedging instrument, and if so, the nature of the risk being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. Where derivatives are designated and highly effective as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedge'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedge'); or (iii) hedges of net investments in a foreign operation ('net investment hedge'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Hedge accounting

It is the group's policy to document, at the inception of a hedging relationship, the relationship between the hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking the hedge. Such policies also require documentation of the assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items attributable to the hedged risks. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives (net of interest accrual) that are designated and qualify as fair value hedging instruments are recorded as 'Net trading income' in the income statement, together with changes in the fair value of the asset or liability that are attributable to the hedged risk.

If the hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised to the income statement over the residual period to maturity in net interest income. Where the adjustment relates to the carrying amount of a hedged available-for-sale equity security, this remains in equity until the disposal of the equity security.

Cash flow hedge

The effective portion of changes in the fair value of derivatives (net of interest accrual) that are designated and qualify as cash flow hedges is recognised in shareholders' equity. Any gain or loss relating to an ineffective portion is recognised immediately in the income statement within 'Net trading income' along with accrued interest.

Amounts accumulated in shareholders' equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from shareholders' equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in shareholders' equity at that time remains in shareholders' equity until the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in shareholders' equity is immediately transferred to the income statement.

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

Net investment hedge

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in shareholders' equity; the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of.

Hedge effectiveness testing

To qualify for hedge accounting, HKAS 39 requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) must also be demonstrated on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted for assessing hedge effectiveness will depend on the risk management strategy.

For fair value hedge relationships, the cumulative dollar offset method or regression analysis are used to test hedge effectiveness. For cash flow hedge relationships, effectiveness is tested by applying the change in variable cash flow method or the cumulative dollar offset method using the hypothetical derivative approach.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness, the changes in fair value or cash flows must offset each other. The group considers that a hedge is highly effective when the offset is within the range of 80 per cent to 125 per cent.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair value of any derivative instrument that does not qualify for hedge accounting under HKAS 39 are recognised immediately in the income statement and reported in 'Net trading income', except where derivative contracts are used with financial instruments designated at fair value, in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'.

From 1 January 2004 to 31 December 2004

Derivative financial instruments comprised futures, forward, swap and option transactions undertaken by the group in the foreign exchange, interest rate, equity, credit derivative, and commodity markets. Netting was applied where a legal right of set-off existed.

Accounting for these instruments was dependent upon whether the transactions were undertaken for trading or non-trading purposes.

Trading transactions

Trading transactions included transactions undertaken for market-making, to service customers' needs and for proprietary purposes, as well as any related hedges.

Transactions undertaken for trading purposes were marked-to-market and the net present value of any gain or loss arising was recognised in the income statement as 'Net trading income', after appropriate deferrals for unearned credit margins and future servicing costs. Derivative trading transactions were valued by reference to an independent liquid price where this was available. For those transactions where there were no readily available quoted prices, which predominantly related to over-the-counter transactions, market values were determined by reference to independently sourced rates, using valuation models. Adjustments were made for illiquid positions where appropriate.

Assets, including gains, resulting from derivative exchange rate, interest rate, equity, credit derivative and commodity contracts which were marked-to-market were included in 'Derivatives' on the assets side of the balance sheet. Liabilities, including losses, resulting from such contracts, were included in 'Derivatives' on the liabilities side of the balance sheet.

3 Principal accounting policies *(continued)*

Non-trading transactions

Non-trading transactions, which were those undertaken for hedging purposes as part of the group's risk management strategy against cash flows, assets, liabilities or positions, were measured on an accrual basis. Non-trading transactions included qualifying hedges and positions that synthetically altered the characteristics of specified financial instruments.

Non-trading transactions were accounted for on an equivalent basis to the underlying assets, liabilities or net positions. Any gain or loss arising was recognised on the same basis as that arising from the related assets, liabilities or positions.

To qualify as a hedge, a derivative was required effectively to reduce the price, foreign exchange or interest rate risk of the asset, liability or anticipated transaction to which it was linked and designated as a hedge at inception of the derivative contract. Accordingly, changes in the market value of the derivative were required to be highly correlated with changes in the market value of the underlying hedged item at inception of the hedge and over the life of the hedge contract. If these criteria were met, the derivative was accounted for on the same basis as the underlying hedged item. Derivatives used for hedging purposes included swaps, forwards and futures. Interest rate swaps were also used to alter synthetically the interest rate characteristics of financial instruments. In order to qualify for synthetic alteration, a derivative instrument had to be linked to specific individual, or pools of similar, assets or liabilities by the notional principal and interest rate risks of the associated instruments, and had to achieve a result that was consistent with defined risk management objectives. If these criteria were met, accruals based accounting was applied, i.e. income or expense was recognised and accrued to the next settlement date in accordance with the contractual terms of the agreement.

Any gain or loss arising on the termination of a qualifying derivative was deferred and amortised to earnings over the original life of the terminated contract. Where the underlying asset, liability or position was sold or terminated, the qualifying derivative was immediately marked-to-market and any gain or loss arising was taken to the income statement.

k *Derecognition of financial assets and liabilities*

Financial assets are derecognised when the rights to receive cash flows from the assets have expired; or where the group has transferred its contractual rights to receive the cash flows of the financial assets and has transferred substantially all the risks and rewards of ownership; or where both control and substantially all the risks and rewards are not retained.

Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged or cancelled or expires.

l *Offsetting financial assets and financial liabilities*

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and the group intends to settle on a net basis, or realise the asset and settle the liability simultaneously. In 2004, netting was applied where a legal right of set-off existed.

m *Subsidiaries and associates*

The group

Subsidiaries are companies in which the group, directly or indirectly, holds more than half of the issued share capital or controls more than half the voting power or controls the composition of the board of directors. Subsidiaries are controlled if the group has the power to govern their financial and operating policies so as to obtain benefits from their activities. Subsidiaries are consolidated in the group's financial statements from the date on which the group obtains control until control ceases.

Balances and transactions between entities that comprise the group, together with unrealised gains and losses thereon, are eliminated in the consolidated financial statements. Minority interests represent the portion of the profit or loss and net assets of subsidiaries attributable to equity interests in those subsidiaries that are not held by the group.

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

Associates are entities over which the group has significant influence but not control or joint control. Investments in associates in the consolidated balance sheet are stated at the group's attributable share of the net assets of the associates using the equity method of accounting.

'Share of profit in associates' is stated in the income statement net of tax.

The Bank

The Bank's investments in subsidiaries and associates are stated at cost less impairment losses, if any.

In previous years, the Bank's investments in subsidiaries and associates were stated at fair value. Gains and losses arising from changes in fair value were accounted for as movements in the 'Reserve arising from the revaluation of subsidiary and associated companies to fair value'. This change in accounting policy was made in order to reflect the fact that the Bank does not intend to dispose of any material subsidiaries and that measuring these investments at fair value in the Bank's separate balance sheet does not provide relevant information. This change does not affect the consolidated financial statements of the group. The change in accounting policy has been applied retrospectively in the Bank's accounts and this resulted in a reduction in the carrying value as at 31 December 2004 of 'Investments in subsidiary companies' of HK\$138,070 million and 'Investments in associates' of HK\$160 million.

n *Goodwill and intangible assets*

- (i) Goodwill arises on business combinations, including the acquisition of subsidiaries or associates when the cost of acquisition exceeds the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities acquired. Goodwill on acquisitions of associates is included in 'Investments in associates'. Goodwill is tested for impairment annually by comparing the present value of the expected future cash flows from a business with the carrying value of its net assets, including attributable goodwill. Goodwill is allocated to cash-generating units for the purposes of impairment testing. Goodwill is tested for impairment at the lowest level at which goodwill is monitored for internal management purposes. Goodwill is stated at cost less accumulated impairment losses which are charged to the income statement.

Negative goodwill is recognised immediately in the income statement as it arises.

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

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

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

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

The accounting policy on the value of the in-force long-term assurance business is set out in Note 3v.

o *Property, plant and equipment*

(i) Premises

Premises held for own use, comprising freehold land and buildings, and leasehold land and buildings where the value of the land cannot be reliably separated from the value of the building at inception of the lease and the premises are not clearly held under an operating lease, are stated at valuation less accumulated depreciation and impairment losses.

3 Principal accounting policies (continued)

Such premises are revalued by professionally qualified valuers with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value. Surpluses arising on revaluation are credited firstly to the income statement to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same premises, and are thereafter taken to the 'Property revaluation reserve'. Deficits arising on revaluation are firstly set off against any previous revaluation surpluses included in the 'Property revaluation reserve' in respect of the same premises, and are thereafter taken to the income statement.

Buildings held for own use which are situated on leasehold land where it is possible to reliably separate the value of the building from the value of the leasehold land at inception of the lease are stated at valuation less accumulated depreciation and impairment losses.

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

- freehold land is not depreciated;
- leasehold land is depreciated over the unexpired terms of the leases;
- buildings and improvements thereto are depreciated at the greater of 2% per annum on the straight line basis or over the unexpired terms of the leases or over the remaining useful lives of the buildings.

(ii) Other plant and equipment

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses. Depreciation is calculated on a straight-line basis to write off the assets over their useful lives, which are generally between 5 and 20 years.

(iii) Investment properties

The group holds certain properties as investments to earn rentals, or for capital appreciation, or both. Investment properties are stated at fair value with changes in fair value being recognised in the income statement (in 'Other operating income') with effect from 1 January 2005. Previously, the change in the fair value of investment properties was recognised in the property revaluation reserve. The comparative income statement for 2004 has not been adjusted to reflect the revaluation of investment properties, as permitted by HKAS 40. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

Property, plant and equipment is subject to review for impairment if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

p Finance and operating leases

- (i) Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. Where the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Advances to customers' as appropriate. Finance income receivable is recognised over the periods of the leases so as to give a constant rate of return on the net investment in the leases.
- (ii) Where the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. The finance lease and corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised over the periods of the leases based on the interest rates implicit in the leases so as to give a constant rate of interest on the remaining balance of the liability.
- (iii) All other leases are classified as operating leases. Where the group is the lessor, the assets subject to the operating leases are included in 'Property, plant and equipment' and accounted for accordingly. Impairment losses are recognised to the extent that the carrying value of equipment is impaired through residual values not being fully recoverable. Where the group is the lessee, the leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

- (iv) There are no freehold interests in land in Hong Kong. Accordingly all such land is considered to be held under operating leases. Unless it qualifies for inclusion in 'Property, plant and equipment' (as described in Note 3o above), such land is included under 'Other assets' in the balance sheet and is stated at cost less amortisation and impairment losses. Amortisation is calculated to write off the cost of the land on a straight-line basis over the terms of the leases, which are generally between 20 and 999 years.

q Income tax

- (i) Income tax for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in reserves, in which case it is recognised in reserves.
- (ii) Current tax is the expected tax payable on the taxable income for the year, calculated using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to set off exists.
- (iii) Deferred tax is recognised on temporary differences between the carrying amount of assets and liabilities in the balance sheet and the amount attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates that have been enacted or substantively enacted at the balance sheet date and are expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group, relate to income taxes levied by the same taxation authority, and a legal right to set off exists in the entity.

Deferred tax relating to actuarial gains and losses arising from post-employment benefit plans which are recognised directly in equity, is also credited or charged directly to equity.

From 1 January 2005, deferred tax relating to fair value re-measurement of available-for-sale investments and cash flow hedges, which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

r Pension and other post-retirement benefits

The group operates a number of pension plans which include both defined benefit and defined contribution plans.

Payments to defined contribution plans and state-managed retirement benefit plans, where the group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The costs recognised for funding defined benefit plans are determined using the projected unit credit method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised in shareholders' equity and presented in the statement of changes in equity in the period they arise. Past service costs are recognised immediately to the extent the benefits are vested, and are otherwise recognised on a straight-line basis over the average period until the benefits are vested. The current service costs and any past service costs together with the expected return on plan assets less the unwinding of the discount on the plan liabilities are charged to operating expenses.

The net defined benefit asset recognised in the balance sheet represents the excess of the fair value of plan assets over the present value of the defined benefit obligations adjusted for unrecognised past service costs. The asset is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The group implemented HK SSAP 34 (which is materially equivalent to HKAS 19) in relation to the accounting for pensions in 2003, and adopted the corridor approach for the recognition of actuarial gains and losses. The group has changed its policy in 2005 to recognise in full actuarial gains and losses in the statement of changes in equity.

3 Principal accounting policies (continued)

s *Share-based payments*

The group grants shares of HSBC Holdings plc to certain employees under various vesting conditions and the group has the obligation to acquire HSBC Holdings plc shares to deliver to the employees upon vesting. The group's liability under such arrangements is measured at fair value at each reporting date. The changes in fair value are recognised as an expense in each period. The main kinds of awards in this category are as follows:

- shares awarded to an employee to join HSBC that are made available immediately, with no vesting period attached to the award, are expensed immediately;
- when an inducement in the form of shares is awarded to an employee on commencement of employment with HSBC, and the employee must complete a specified period of service before the inducement vests, the expense is spread over the period to vesting;
- discretionary bonuses awarded in respect of service in the past, are expensed over the vesting period which, in this case, is the period from the date the bonus is announced until the award vests.

For share options granted to employees of the group directly by HSBC Holdings plc, the compensation expense to be spread over the vesting period is determined by reference to the fair value of the options on grant date, and the impact of any non-market vesting conditions such as option lapses. The expense is recognised over the vesting period. The corresponding amount is credited to 'Other reserves'.

t *Foreign currencies*

- (i) Items included in each of the group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The group's financial statements are presented in Hong Kong dollars which is the Bank's functional and presentation currency.
- (ii) Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined.
- (iii) The results of branches, subsidiaries and associates not reporting in Hong Kong dollars are translated into Hong Kong dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period-end are accounted for in a separate foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate subsidiary financial statements. In consolidated financial statements, these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

u *Provisions*

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

Notes on the Accounts (continued)

3 Principal accounting policies (continued)

v Insurance contracts

From 1 January 2005

Through its insurance subsidiaries, the group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the group accepts significant insurance risk from another party, by agreeing to compensate that party on the occurrence of a specified uncertain future event, is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

Insurance contracts are accounted for as follows:

Premiums

Gross insurance premiums for general insurance business are reported as income over the term of the insurance contract attributable to the risks borne during the accounting period. The unearned premium or the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date is calculated on a daily or monthly pro-rata basis.

Premiums for life assurance are accounted for when receivable, except in unit-linked business where premiums are accounted for when liabilities are established.

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

Claims and reinsurance recoveries

Gross insurance claims for general insurance business include paid claims and movements in outstanding claims reserves. The outstanding claims reserves are based on the estimated ultimate cost of all claims that have occurred but not settled at the balance sheet date, whether reported or not, together with related claim handling costs and a reduction for the expected value of salvage and other recoveries. Reserves for claims incurred but not reported ('IBNR') are made on an estimated basis, using appropriate statistical techniques.

Gross insurance claims for life assurance reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. The technical reserves for non-linked liabilities (long-term business provision) are calculated by each life assurance operation based on local actuarial principles. The technical reserves for linked liabilities are at least the element of any surrender or transfer value which is calculated by reference to the relevant fund or funds or index. Some insurance contracts may contain discretionary participation features whereby the policyholder is entitled to additional payments whose amount and/or timing is at the discretion of the issuer. The discretionary element of these contracts is included in 'Liabilities under insurance contracts issued'.

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

Value of long-term assurance business

A value is placed on insurance contracts that are classified as long-term assurance business, and are in force at the balance sheet date.

The value of in-force long-term assurance business is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as recent experience and general economic conditions. Movements in the value of in-force long-term assurance business are included in 'Other operating income' on a gross of tax basis.

3 Principal accounting policies (continued)

w *Investment contracts*

Customer liabilities under unit-linked investment contracts and the linked financial assets are designated at fair value, and the movements in fair value are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services.

The incremental costs directly related to the acquisition of new investment contracts or renewal of existing investment contracts are capitalised and amortised over the period of the provision of the investment management services.

x *Dividends*

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

y *Debt securities in issue and subordinated liabilities*

From 1 January 2005

Debt securities issued for trading purposes or designated at fair value are reported under the appropriate balance sheet captions. Other debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest rate method and are reported under 'Debt securities in issue' or 'Subordinated liabilities'.

From 1 January 2004 to 31 December 2004

Debt securities in issue were measured at cost adjusted for amortised premiums and discounts, and were reported under 'Debt securities in issue' or 'Subordinated liabilities'.

z *Cash and cash equivalents*

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments comprise cash and balances with banks maturing within one month, and treasury bills and certificates of deposit with less than three months' maturity from the date of acquisition.

aa *Share capital*

From 1 January 2005

Shares are classified as equity when the group has the unconditional right to avoid transferring cash or other financial assets.

From 1 January 2004 to 31 December 2004

Share capital included preference shares issued by the group. These have been reclassified as liabilities upon the adoption of HKAS 32.

Notes on the Accounts (continued)**4 Operating profit**

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

a Interest income

	2005	2004
	HK\$m	HK\$m
		Restated
Interest income on listed securities	3,320	3,479
Interest income on unlisted securities	16,800	11,925
Other interest income	65,614	42,543
	85,734	57,947
Less: interest income classified as 'Net trading income' (Note 4c)	(4,989)	–
Less: interest income classified as 'Net income from financial instruments designated at fair value' (Note 4d)	(546)	–
	80,199	57,947

Among the above is interest income accrued on impaired financial assets of HK\$208 million, which includes interest income on unwinding of discount on loan impairment losses of HK\$81 million (Note 16a) for the year ended 31 December 2005.

b Interest expense

	2005	2004
	HK\$m	HK\$m
		Restated
Interest expense on subordinated liabilities, other debt securities in issue, customer deposits and deposits by banks maturing after five years	1,243	1,079
Interest expense on preference shares	3,010	1,540
Other interest expense	38,968	18,358
	43,221	20,977
Less: interest expense classified as 'Net trading income' (Note 4c)	(6,473)	–
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (Note 4d)	(40)	–
	36,708	20,977

4 Operating profit (continued)

c Net trading income

	2005 HK\$m	2004 HK\$m Restated
Dealing profits		
– Foreign exchange	5,548	4,680
– Interest rate derivatives	2,442	2,380
– Debt securities	278	(260)
– Equities and other trading	292	203
	8,560	7,003
Loss from hedging activities		
Fair value hedges		
– Net loss on hedged items attributable to the hedged risk	(1,085)	–
– Net gain on hedging instruments	1,085	–
Cash flow hedges		
– Net hedging loss	(1)	–
	(1)	–
Interest on trading assets and liabilities		
– Interest income (Note 4a)	4,989	–
– Interest expense (Note 4b)	(6,473)	–
	(1,484)	–
Dividend income from trading securities		
– Listed investments	105	–
	7,180	7,003

d Net income from financial instruments designated at fair value

	2005 HK\$m	2004 HK\$m
Income on assets designated at fair value which back insurance and investment contracts	1,186	–
Change in fair value of investment contracts relating to insurance entities	(1,164)	–
	22	–
Net change in fair value of other financial assets/liabilities designated at fair value	(144)	–
Interest on financial assets and liabilities designated at fair value		
– Interest income (Note 4a)	546	–
– Interest expense (Note 4b)	(40)	–
	506	–
	384	–
Net investment income on assets backing insurance and investment contracts		
– Interest income	–	1,040
– Dividend income	–	203
– Dealing income	–	1,177
	–	2,420
Investment income allocated to investment contracts liabilities	–	(1,522)
Net investment income on assets backing policyholder liabilities	–	898

Notes on the Accounts (continued)**4 Operating profit** (continued)**e Gains less losses from financial investments**

	2005	2004
	HK\$m	HK\$m
		Restated
Profit on disposal of available-for-sale securities	762	–
Profit on disposal of long-term investments	–	1,311
Reversal of impairment of long-term investments	–	186
Other	(6)	–
	<u>756</u>	<u>1,497</u>

f Dividend income

	2005	2004
	HK\$m	HK\$m
		Restated
Listed investments	102	100
Unlisted investments	266	63
	<u>368</u>	<u>163</u>

4 Operating profit (continued)

g Net earned insurance premiums

2005	<i>Non-life insurance</i>	<i>Life insurance (non-linked)</i>	<i>Life insurance (linked)</i>	<i>Investment contracts with discretionary participation features</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Gross written premiums	2,009	16,358	1,453	84	19,904
Movement in unearned premiums	(54)	–	–	–	(54)
Gross earned premiums	1,955	16,358	1,453	84	19,850
Gross written premiums ceded to reinsurers	(397)	(93)	(5)	–	(495)
Reinsurers' share of movement in unearned premiums	(15)	–	–	–	(15)
Reinsurers' share of gross earned premiums	(412)	(93)	(5)	–	(510)
Net earned premiums	<u>1,543</u>	<u>16,265</u>	<u>1,448</u>	<u>84</u>	<u>19,340</u>

2004	<i>Non-life insurance</i>	<i>Life insurance (non-linked)</i>	<i>Life insurance (linked)</i>	<i>Investment contracts with discretionary participation features</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Gross written premiums	1,941	9,732	2,944	–	14,617
Movement in unearned premiums	(7)	–	–	–	(7)
Gross earned premiums	1,934	9,732	2,944	–	14,610
Gross written premiums ceded to reinsurers	(423)	(79)	(4)	–	(506)
Reinsurers' share of movement in unearned premiums	(19)	–	–	–	(19)
Reinsurers' share of gross earned premiums	(442)	(79)	(4)	–	(525)
Net earned premiums	<u>1,492</u>	<u>9,653</u>	<u>2,940</u>	<u>–</u>	<u>14,085</u>

h Other operating income

	2005 HK\$m	2004 HK\$m Restated
Rental income from investment properties	215	211
Movement in present value of in-force insurance business	1,185	833
Profit on disposal of property, plant and equipment	104	192
Profit on disposal of subsidiaries and associates	53	342
Surplus arising on property revaluation	1,537	1,038
Other	1,803	1,498
	<u>4,897</u>	<u>4,114</u>

Notes on the Accounts (continued)

4 Operating profit (continued)

i Net insurance claims incurred and movement in policyholder liabilities

	<i>Non-life insurance</i>	<i>Life insurance (non-linked)</i>	<i>Life insurance (linked)</i>	<i>Investment contracts with discretionary participation features</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
2005					
Claims, benefits and surrenders paid	713	460	1,071	–	2,244
Movement in provision	(106)	14,408	741	70	15,113
Gross claims incurred and movement in policyholder liabilities	607	14,868	1,812	70	17,357
Reinsurers' share of claims, benefits and surrenders paid	(118)	(32)	(2)	–	(152)
Reinsurers' share of movement in provision	86	1	(1)	–	86
Reinsurers' share of claims incurred and movement in policyholder liabilities	(32)	(31)	(3)	–	(66)
Net insurance claims incurred and movement in policyholder liabilities	<u>575</u>	<u>14,837</u>	<u>1,809</u>	<u>70</u>	<u>17,291</u>
	<i>Non-life insurance</i>	<i>Life insurance (non-linked)</i>	<i>Life insurance (linked)</i>	<i>Investment contracts with discretionary participation features</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
2004					
Claims, benefits and surrenders paid	771	247	254	–	1,272
Movement in provision	38	8,198	2,448	–	10,684
Gross claims incurred and movement in policyholder liabilities	809	8,445	2,702	–	11,956
Reinsurers' share of claims, benefits and surrenders paid	(199)	(26)	(5)	–	(230)
Reinsurers' share of movement in provision	–	(1)	–	–	(1)
Reinsurers' share of claims incurred and movement in policyholder liabilities	(199)	(27)	(5)	–	(231)
Net insurance claims incurred and movement in policyholder liabilities	<u>610</u>	<u>8,418</u>	<u>2,697</u>	<u>–</u>	<u>11,725</u>

4 Operating profit (continued)

j Loan impairment charges and other credit risk provisions

	2005 HK\$m	2004 HK\$m Restated
Net charge/(release) for impairment provisions		
Advances to customers		
– Individually assessed impairment provisions		
New provisions	2,127	4,016
Releases	(1,755)	(2,450)
Recoveries	(267)	(617)
	105	949
– Net charge/(release) for collectively assessed Impairment provisions	1,961	(1,723)
– Country risk provision	2	–
	<u>2,068</u>	<u>(774)</u>
Placings with banks maturing after one month		
– Net release of individually assessed provisions	–	(1)
	<u>2,068</u>	<u>(775)</u>
Net release of other credit risk provisions	(4)	(87)
Net charge/(release) for impairment provisions and other credit risk provisions	<u>2,064</u>	<u>(862)</u>

k Employee compensation and benefits

	2005 HK\$m	2004 HK\$m Restated
Wages, salaries and other costs	16,428	13,816
Social security costs	238	184
Retirement benefit costs		
– Defined contribution plans	284	207
– Defined benefit plans	778	555
– Other retirement benefits	8	3
	<u>17,736</u>	<u>14,765</u>

Retirement benefit pension plans

The group operates 52 (2004: 49) retirement benefit schemes, with a total cost of HK\$1,070 million (2004 restated: HK\$765 million), of which HK\$275 million (2004 restated: HK\$169 million) relates to overseas schemes.

Progressively, the group has been moving to defined contribution plans for all new employees.

The majority of the schemes, which cover 49% (2004: 54%) of the group's employees, are funded defined benefit schemes with assets which, in the case of the larger schemes, are held either under insurance policies or in trust funds separate from the group. The cost relating to these schemes was HK\$739 million (2004 restated: HK\$541 million) which was assessed in accordance with the advice of qualified actuaries; the schemes are reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the projected benefit obligations of the group's retirement benefit schemes vary according to the economic conditions of the countries in which they are situated.

Notes on the Accounts (continued)**4 Operating profit** (continued)(i) *Defined benefit plan principal actuarial assumptions*

The principal actuarial financial assumptions used to calculate the major defined benefit pension plans were:

	2005	2004
	% p.a.	% p.a.
Discount rate	4.2	4.0
Expected rate of return on plan assets		
– equities	8.0	9.5
– fixed income	4.0	4.0
– other	5.0	2.0
Inflation assumption	n/a	n/a
Rate of increase for pensions in payment	n/a	n/a
Rate of pay increase		
– long term	3.0	3.0
Mortality table	HKLT95*	HKLT95*

* Hong Kong Life Tables version 1995

(ii) *Value recognised in the balance sheet*

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Equities	4,955	4,473	2,784	2,542
Bonds	6,055	6,039	3,925	3,730
Other	2,334	2,094	1,890	1,823
Fair value of plan assets	13,344	12,606	8,599	8,095
Present value of funded obligations	11,753	11,486	7,538	7,255
Present value of unfunded obligations	197	140	188	134
Defined benefit obligations	11,950	11,626	7,726	7,389
Net defined benefit asset	1,394	980	873	706
Reported as ‘Assets’	1,788	1,307	1,252	1,026
Reported as ‘Liabilities’	(394)	(327)	(379)	(320)
Net defined benefit asset	1,394	980	873	706

4 Operating profit (continued)

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

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
At 1 January	11,626	10,329	7,389	6,714
Current service cost	742	664	493	452
Interest cost	481	562	307	362
Contributions by employees	2	1	1	–
Actuarial (gains)/losses	(77)	671	12	289
Benefits paid	(860)	(572)	(482)	(390)
Past service cost – vested immediately	–	3	–	3
Gains on curtailments	–	(73)	–	(73)
Losses on settlements	7	–	7	–
Exchange and other movements	29	41	(1)	32
At 31 December	11,950	11,626	7,726	7,389

(iv) Changes in the fair value of plan assets

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
At 1 January	12,606	11,561	8,095	7,534
Expected return	722	665	455	424
Contributions by the group	736	811	454	483
Contributions by employees	2	1	1	–
Actuarial gains/(losses)	67	99	(7)	–
Benefits paid	(830)	(548)	(455)	(363)
Exchange and other movements	41	17	56	17
At 31 December	13,344	12,606	8,599	8,095

The plan assets above included ordinary shares issued by:

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
HSBC Holdings plc	606	608	437	434
Hang Seng Bank Limited	–	17	–	16
	606	625	437	450

The actual return on plan assets for the year ended 31 December 2005 was HK\$789 million (2004: HK\$764 million).

The group expects to make HK\$706 million of contributions to defined benefit pension plans during the following year. Contributions to be made by the Bank are expected to be HK\$419 million.

Notes on the Accounts (continued)**4 Operating profit** (continued)

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

	<i>Group</i>	
	2005	2004
	HK\$m	HK\$m
		Restated
Current service cost	742	664
Interest cost	481	562
Expected return on plan assets	(722)	(665)
Past service cost	–	3
(Gains)/losses on curtailments and settlements	7	(73)
Total net expense	508	491

Total net actuarial gains recognised in the group's retained profits during 2005 in respect of defined benefit pension plans after deduction of minority interests were HK\$73 million (2004: HK\$453 million loss). Total net actuarial gains recognised directly through retained profits after deduction of minority interests were HK\$57 million (2004: HK\$16 million loss).

Total net actuarial losses recognised in the Bank's retained profits during 2005 in respect of defined benefit pension plans were HK\$17 million (2004: HK\$288 million loss). Total net actuarial losses recognised directly through retained profits after deduction of minority interests were HK\$23 million (2004: HK\$6 million loss).

Total effect of limit on plan surpluses in 2005 in respect of defined benefit pension plans was HK\$nil (2004: HK\$nil).

Expenses recognised in the income statement in respect of defined benefit schemes sponsored by the Bank's immediate holding company, HSBC Asia Holdings BV ('HABV'), amounted to HK\$270 million (2004 restated: HK\$64 million) and were not included in the tables above.

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

The International Staff Scheme is denominated in Sterling. Information is set out below regarding the International Staff Scheme. The assets and liabilities of the International Staff Scheme are not included in the group's or the Bank's accounts.

Assumptions as at 1 January 2005

	% p.a.
Inflation	2.70
Salary increases	4.45
Pension increases	2.70
Discount rate	5.30
Expected return on assets	5.50
Mortality table	PA92C2036*

* This table "PA92C2036" is based on the 92 series of tables prepared by the Continuous Mortality Investigation of the Institute and Faculty of Actuaries, projected to the year 2036 allowing for improvements in mortality underlying the series.

4 Operating profit (continued)

The International Staff Scheme

Funded status at 31 December 2005

	£m
Plan assets	510
Defined benefit obligations	<u>(575)</u>
Defined benefit liability	<u>(65)</u>

Categories of assets at 31 December 2005

	£m
Bonds	250
Property	46
Other	<u>214</u>
Total market value of assets	<u>510</u>

Reconciliation of defined benefit obligations at 31 December 2005

	£m
Defined benefit obligations at 1 January 2005	493
Service cost	15
Interest cost	26
Employee contributions	2
Actuarial losses	62
Actual benefit payments	<u>(23)</u>
Defined benefit obligations at 31 December 2005	<u>575</u>

Reconciliation of the value of plan assets at 31 December 2005

	£m
Value of assets at 1 January 2005	417
Expected return on assets	23
Actuarial gains on assets	37
Actual company contributions	54
Employee contributions	2
Actual benefit payments	<u>(23)</u>
Value of assets at 31 December 2005	<u>510</u>

Estimated contributions in the following year

	£m
Estimated company contributions in financial year	15
Estimated employee contributions in financial year	<u>2</u>
Estimated total contributions in financial year 2006	<u>17</u>

Notes on the Accounts (continued)**4 Operating profit** (continued)

(vi) Amounts for the current and previous years

	Group				Bank			
	2005 HK\$m	2004 HK\$m	2003 HK\$m	2002 HK\$m	2005 HK\$m	2004 HK\$m	2003 HK\$m	2002 HK\$m
Defined benefit obligations	11,950	11,626	10,329	9,829	7,726	7,389	6,714	6,311
Plan assets	13,344	12,606	11,561	10,245	8,599	8,095	7,534	6,730
Net surplus	1,394	980	1,232	416	873	706	820	419
Experience (gains)/losses on plan liabilities	84	(28)	(281)	(410)	71	(76)	(230)	(270)
Experience gains/(losses) on plan assets	67	99	611	(1,028)	2	9	283	(517)

1 General and administrative expenses

	2005 HK\$m	2004 HK\$m Restated
Premises and equipment		
– Rental expenses	1,243	1,144
– Amortisation of prepaid operating lease payments	56	55
– Other premises and equipment	2,089	1,761
	3,388	2,960
Other administrative expenses	8,394	7,202
Litigation and other provisions	313	131
	12,095	10,293

Included in operating expenses are direct operating expenses of HK\$26 million (2004: HK\$25 million) arising from investment properties that generated rental income during the year. Direct operating expenses arising from investment properties that did not generate rental income amounted to HK\$3 million (2004: HK\$4 million).

Included in operating expenses are minimum lease payments under operating leases of HK\$1,143 million (2004: HK\$983 million).

m Auditors' remuneration

Auditors' remuneration amounted to HK\$59 million (2004: HK\$50 million), of which HK\$29 million (2004: HK\$25 million) related to the Bank.

n Directors' emoluments

Key management compensation includes aggregate emoluments of the directors of the Bank calculated in accordance with section 161 of the Hong Kong Companies Ordinance of HK\$115 million (2004*: HK\$68 million). This comprises fees of HK\$7 million (2004: HK\$7 million) and other emoluments of HK\$108 million (2004*: HK\$61 million) which include pension benefits of HK\$4 million (2004: HK\$3 million).

* 2004 comparatives have been restated to include share-based payments.

5 Tax expense

- a The Bank and its subsidiary companies in Hong Kong have provided for Hong Kong profits tax at the rate of 17.5% (2004: 17.5%) on the profits for the year assessable in Hong Kong. Overseas branches and subsidiary companies have similarly provided for tax in the countries in which they operate at the appropriate rates of tax ruling in 2005. Deferred taxation is provided for in accordance with the group's accounting policy in Note 3q.

The charge for taxation in the income statement comprises:

	2005	2004
	HK\$m	HK\$m
		Restated
Current income tax		
– Hong Kong profits tax	4,974	3,982
– Overseas taxation	2,598	2,497
Deferred taxation (Note 31)	479	509
	8,051	6,988

- b Provisions for taxation

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Hong Kong profits tax	635	682	117	116
Overseas taxation	1,409	1,651	1,340	1,590
Current taxation	2,044	2,333	1,457	1,706
Deferred taxation	3,729	3,395	1,238	1,405
	5,773	5,728	2,695	3,111

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

	2005	2004
	HK\$m	HK\$m
		Restated
Profit before tax	45,249	43,536
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	8,714	8,213
Tax effect of non-taxable revenue (net of non-deductible expenses)	(645)	(457)
Tax effect of prior years' tax losses utilised this year (net of unused tax losses not recognised)	(21)	35
Effect on opening deferred tax balances resulting from change in tax rate during the year	–	(2)
Over provision in prior years	(206)	(230)
Others	209	(571)
	8,051	6,988

Notes on the Accounts (continued)**6 Profit attributable to shareholders**

The consolidated profit attributable to shareholders includes a profit of HK\$27,578 million (2004 restated: HK\$29,405 million) which has been dealt with in the accounts of the Bank.

7 Dividends

	2005		2004	
	HK\$ per share	HK\$m	HK\$ per share	HK\$m
Ordinary dividends				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	0.53	4,800	1.30	8,450
– first interim dividend paid	0.51	4,600	0.92	6,000
– second interim dividend paid	0.67	6,000	0.73	4,750
– third interim dividend paid	0.58	5,200	0.53	4,750
	2.29	20,600	3.48	23,950

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2005 of HK\$4,500 million (HK\$0.50 per ordinary share).

8 Cash and short-term funds

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m Restated	2005 HK\$m	2004 HK\$m Restated
Cash in hand and current balances with banks	31,230	21,034	21,533	14,853
Balances with central banks	55,652	33,475	54,849	32,769
Placings with banks with remaining maturity of one month or less	310,396	336,292	253,154	274,744
Treasury bills	105,452	119,843	100,593	112,217
	502,730	510,644	430,129	434,583

Deposits required by overseas government regulations are included in the above figures as follows:

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Balances with banks and central banks	8,025	7,805	7,530	7,416
Treasury bills	427	422	351	336
	8,452	8,227	7,881	7,752

8 Cash and short-term funds (continued)

Treasury bills are analysed as follows:–

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m Restated	2005 HK\$m	2004 HK\$m Restated
Held for trading purposes				
– at fair value	–	31,244	–	27,579
Held-to-maturity				
– at amortised cost	–	88,599	–	84,638
– at fair value	–	88,621	–	84,645
Available-for-sale				
– at fair value	105,452	–	100,593	–
	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Treasury bills – available-for-sale				
– which may be repledged or resold by counterparties	236	–	142	–
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	105,216	–	100,451	–
	105,452	–	100,593	–

Treasury bills held for trading have been reclassified from ‘Cash and short-term funds’ to ‘Trading assets’. All treasury bills are unlisted.

9 Placings with banks maturing after one month

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m Restated	2005 HK\$m	2004 HK\$m Restated
Gross placings with banks maturing after one month	69,554	74,711	53,205	56,543
Fair value	69,545	74,792	53,198	56,538

There were no rescheduled and overdue placings included in the above table.

Notes on the Accounts (continued)**10 Certificates of deposit**

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Held-to-maturity – at amortised cost	2,716	51,743	–	12,441
Available-for-sale	51,115	–	23,001	–
	53,831	51,743	23,001	12,441
Held-to-maturity – fair value	2,950	51,848	–	12,367

Certificates of deposit held are largely unlisted.

There was no disposal of held-to-maturity certificates of deposit during the year.

11 Hong Kong SAR currency notes in circulation

The Hong Kong SAR currency notes in circulation are secured by the deposit of funds in respect of which the Government of the Hong Kong SAR certificates of indebtedness are held.

12 Trading assets

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Trading assets				
– which may be repledged or resold by counterparties	12,550	–	234	–
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	203,131	–	172,935	–
	215,681	–	173,169	–
	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Debt securities	108,687	82,159	80,246	79,154
Equity shares	22,677	5,573	22,008	4,569
Treasury bills	69,880	–	67,286	–
Other	14,437	–	3,629	–
	215,681	87,732	173,169	83,723

All treasury bills are unlisted.

12 Trading assets (continued)

a Debt securities

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Listed				
– listed in Hong Kong	13,606	17,890	12,839	17,197
– listed outside Hong Kong	36,934	31,555	33,294	30,731
	50,540	49,445	46,133	47,928
Unlisted	58,147	32,714	34,113	31,226
	108,687	82,159	80,246	79,154
Issued by public bodies				
– central governments and central banks	48,387	23,874	28,778	22,168
– other public sector entities	5,266	5,862	3,778	5,909
	53,653	29,736	32,556	28,077
Issued by other bodies				
– banks	15,234	15,923	11,457	15,060
– corporate entities	39,800	36,500	36,233	36,017
	108,687	82,159	80,246	79,154

b Equity shares

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Listed				
– listed in Hong Kong	2,281	1,379	2,264	1,379
– listed outside Hong Kong	9,351	618	9,330	3
	11,632	1,997	11,594	1,382
Unlisted	11,045	3,576	10,414	3,187
	22,677	5,573	22,008	4,569
Issued by other bodies				
– banks	1,081	524	1,081	524
– corporate entities	21,596	5,049	20,927	4,045
	22,677	5,573	22,008	4,569

13 Financial assets designated at fair value

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Debt securities	15,070	–	5,166	–
Equity shares	18,320	–	–	–
Treasury bills	94	–	–	–
Other	3,589	–	3,589	–
	37,073	–	8,755	–

All treasury bills are unlisted.

Notes on the Accounts (continued)**13 Financial assets designated at fair value** (continued)**a Debt securities**

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed				
– listed in Hong Kong	1,220	–	1,014	–
– listed outside Hong Kong	4,309	–	2,157	–
	5,529	–	3,171	–
Unlisted	9,541	–	1,995	–
	15,070	–	5,166	–
	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Issued by public bodies				
– central governments and central banks	3,514	–	1,634	–
– other public sector entities	1,039	–	493	–
	4,553	–	2,127	–
Issued by other bodies				
– banks	7,410	–	1,437	–
– corporate entities	3,107	–	1,602	–
	15,070	–	5,166	–

b Equity shares

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed				
– listed in Hong Kong	6,269	–	–	–
– listed outside Hong Kong	9,107	–	–	–
	15,376	–	–	–
Unlisted	2,944	–	–	–
	18,320	–	–	–
Issued by other bodies				
– banks	26	–	–	–
– corporate entities	18,294	–	–	–
	18,320	–	–	–

14 Derivatives

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

Derivatives enable users to increase, reduce or alter exposure to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks.

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. Asset and liability values represent the cost to the group of replacing all transactions, with positive or negative fair value respectively, assuming that all the group's relevant counterparties default at the same time, and that transactions can be replaced instantaneously.

Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis. Changes in the values of derivatives are recognised in 'Net trading income' or 'Net income from financial instruments designated at fair value' unless they qualify as hedges for accounting purposes.

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge the group's own risks. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in HKAS 39. All other derivative instruments are classified as held for trading.

The held for trading classification includes two types of derivative instruments: those used in sales and trading activities, and those instruments that are used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second type of held for trading category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivatives activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with offsetting deals being utilised to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures as are used for traditional lending.

(a) Trading derivatives

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

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives and ineffective hedging derivatives. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

Notes on the Accounts (continued)**14 Derivatives** (continued)

Gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value'.

(i) *Contract amounts of derivatives held for trading purposes by product type*

	2005	
	<i>Group</i>	<i>Bank</i>
	HK\$m	HK\$m
Exchange rate	3,420,841	3,237,954
Interest rate	5,300,958	5,179,116
Equity	73,864	72,670
Credit	183,424	183,366
Commodity and other	31,731	42,722
Total derivatives	9,010,818	8,715,828

(ii) *Fair values of derivative open positions by product**Group*

	2005		2004	
	Assets	Liabilities	Assets	Liabilities
	HK\$m	HK\$m	HK\$m	HK\$m
Exchange rate	31,074	29,254	54,247	54,302
Interest rate	36,004	35,739	38,430	36,185
Equity	1,388	2,570	1,475	1,518
Credit	970	2,802	240	351
Commodity and other	288	568	6	6
Total	69,724	70,933	94,398	92,362

Bank

	2005		2004	
	Assets	Liabilities	Assets	Liabilities
	HK\$m	HK\$m	HK\$m	HK\$m
Exchange rate	30,211	28,826	52,682	52,947
Interest rate	35,709	35,148	37,694	35,662
Equity	1,395	3,601	1,470	1,513
Credit	969	2,802	240	351
Commodity	288	435	6	6
Total	68,572	70,812	92,092	90,479

(iii) *Risk exposure by counterparty*

	2005		2004	
	<i>Group</i>	<i>Bank</i>	<i>Group</i>	<i>Bank</i>
	%	%	%	%
Governments	1	1	1	1
Banks	66	66	72	73
Other financial institutions	13	13	11	11
Other	20	20	16	15
Total	100	100	100	100

14 Derivatives (continued)

(b) Hedging instruments

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to mitigate the market risk which would otherwise arise from imbalances in the maturity and other profiles of its assets and liabilities.

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or net investment hedges. These are described under the relevant headings below.

(i) Contract amounts of derivatives held for hedging purposes by product type

2005	Group		Bank	
	Cash flow hedge HK\$m	Fair value hedge HK\$m	Cash flow hedge HK\$m	Fair value hedge HK\$m
Interest rate				
– pay fixed swaps	–	78,168	–	52,229
– receive fixed swaps	211,220	–	161,559	–
Total derivatives	<u>211,220</u>	<u>78,168</u>	<u>161,559</u>	<u>52,229</u>

(ii) Fair values of outstanding derivatives designated as fair value hedges

2005	Group		Bank	
	Assets HK\$m	Liabilities HK\$m	Assets HK\$m	Liabilities HK\$m
Interest rate	658	437	407	274
Total	<u>658</u>	<u>437</u>	<u>407</u>	<u>274</u>

(iii) Fair values of outstanding derivatives designated as cash flow hedges

2005	Group		Bank	
	Assets HK\$m	Liabilities HK\$m	Assets HK\$m	Liabilities HK\$m
Interest rate	1,657	639	1,349	324

The cash flows of the above hedging derivatives are expected to affect the income statement for 2006.

(c) Credit equivalent amounts and risk-weighted amounts

The tables below give the nominal contract amounts, credit equivalent amounts and risk-weighted amounts of derivatives. The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Third Schedule of the Hong Kong Banking Ordinance on capital adequacy and depend on the status of the counterparty and the maturity characteristics. The risk weights used range from 0% to 50%. The group has executed close-out netting agreements with certain counterparties, which allow for positive and negative mark-to-market values on different transactions to be offset and settled by a single payment in the event of default by either party. These have been taken into account in calculating total risk weighted assets.

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.

Notes on the Accounts (continued)**14 Derivatives** (continued)*Group*

	2005			2004		
	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Exchange rate contracts:						
Spot and forward foreign exchange	2,536,795	36,655	9,753	2,411,793	46,694	11,759
Swaps and other exchange rate contracts	884,046	41,124	12,481	696,883	39,635	11,180
	<u>3,420,841</u>	<u>77,779</u>	<u>22,234</u>	<u>3,108,676</u>	<u>86,329</u>	<u>22,939</u>
Interest rate contracts:						
Interest rate swaps	4,775,236	55,580	14,442	3,754,053	57,131	14,679
Other interest rate contracts	815,110	4,159	1,340	684,692	3,117	875
	<u>5,590,346</u>	<u>59,739</u>	<u>15,782</u>	<u>4,438,745</u>	<u>60,248</u>	<u>15,554</u>
Other derivative contracts	<u>289,019</u>	<u>15,885</u>	<u>5,649</u>	<u>71,395</u>	<u>4,030</u>	<u>1,222</u>
Impact of counterparty netting agreements on derivatives exposure	<u>–</u>	<u>(55,354)</u>	<u>(11,915)</u>	<u>–</u>	<u>(59,487)</u>	<u>(12,535)</u>

Bank

	2005			2004		
	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Exchange rate contracts:						
Spot and forward foreign exchange	2,368,618	35,266	9,421	2,282,995	45,564	11,427
Swaps and other exchange rate contracts	869,336	40,931	12,441	675,157	39,344	11,088
	<u>3,237,954</u>	<u>76,197</u>	<u>21,862</u>	<u>2,958,152</u>	<u>84,908</u>	<u>22,515</u>
Interest rate contracts:						
Interest rate swaps	4,599,457	54,440	14,234	3,605,609	56,277	14,502
Other interest rate contracts	793,447	4,202	1,348	681,643	3,071	863
	<u>5,392,904</u>	<u>58,642</u>	<u>15,582</u>	<u>4,287,252</u>	<u>59,348</u>	<u>15,365</u>
Other derivative contracts	<u>298,758</u>	<u>16,452</u>	<u>5,934</u>	<u>71,509</u>	<u>4,060</u>	<u>1,208</u>
Impact of counterparty netting agreements on derivatives exposure	<u>–</u>	<u>(55,354)</u>	<u>(11,915)</u>	<u>–</u>	<u>(59,487)</u>	<u>(12,535)</u>

15 Advances to customers

a Advances to customers

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Gross advances to customers*	1,005,902	927,121	669,993	604,083
Impairment allowances (Note 16a)	(6,576)	(7,929)	(5,348)	(6,409)
	999,326	919,192	664,645	597,674
Fair value	997,439	925,792	663,926	602,000

* Gross advances to customers are stated net of interest in suspense for 2004 only.

Included in advances to customers are:

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Trade bills	42,931	44,536	36,572	38,713
Individually assessed impairment allowances	(236)	(435)	(227)	(430)
	42,695	44,101	36,345	38,283

Notes on the Accounts (continued)**15 Advances to customers** (continued)**b Analysis of advances to customers based on categories used by the HSBC Group**

The following analysis of advances to customers is based on categories used by the HSBC Group, including The Hongkong and Shanghai Banking Corporation Limited and its subsidiary companies, to manage associated risks.

*Group***2005**

	<u>Hong Kong</u>	<u>Rest of Asia-Pacific</u>	<u>Americas/ Europe</u>	<u>Total</u>
	HK\$m	HK\$m	HK\$m	HK\$m
Residential mortgages	182,257	117,211	4	299,472
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	36,291	–	–	36,291
Other personal	57,362	47,855	1	105,218
Total personal	275,910	165,066	5	440,981
Commercial, industrial and international trade	129,774	110,668	–	240,442
Commercial real estate	97,364	32,615	–	129,979
Other property-related lending	47,661	17,340	–	65,001
Government	2,347	5,891	–	8,238
Other commercial	53,681	37,851	–	91,532
Total corporate and commercial	330,827	204,365	–	535,192
Non-bank financial institutions	15,246	11,987	–	27,233
Settlement accounts	2,173	323	–	2,496
Total financial	17,419	12,310	–	29,729
Gross advances to customers	624,156	381,741	5	1,005,902
Impairment allowances	(3,092)	(3,484)	–	(6,576)
Net advances to customers	621,064	378,257	5	999,326

2004 (Restated)

	<u>Hong Kong</u>	<u>Rest of Asia-Pacific</u>	<u>Americas/ Europe</u>	<u>Total</u>
	HK\$m	HK\$m	HK\$m	HK\$m
Residential mortgages	184,631	98,516	2	283,149
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	41,845	–	–	41,845
Other personal	50,741	37,873	7	88,621
Total personal	277,217	136,389	9	413,615
Commercial, industrial and international trade	109,655	105,133	–	214,788
Commercial real estate	80,726	27,956	5	108,687
Other property-related lending	46,319	14,070	–	60,389
Government	4,781	5,150	–	9,931
Other commercial	56,607	35,006	–	91,613
Total corporate and commercial	298,088	187,315	5	485,408
Non-bank financial institutions	15,008	9,148	–	24,156
Settlement accounts	3,470	472	–	3,942
Total financial	18,478	9,620	–	28,098
Gross advances to customers	593,783	333,324	14	927,121
Impairment allowances	(4,032)	(3,892)	(5)	(7,929)
Net advances to customers	589,751	329,432	9	919,192

15 Advances to customers (continued)

Bank

2005	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>Americas/ Europe</i>	<i>Total</i>
	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>
Residential mortgages	93,797	82,616	–	176,413
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	13,412	–	–	13,412
Other personal	41,063	40,764	1	81,828
Total personal	148,272	123,380	1	271,653
Commercial, industrial and international trade	87,869	101,320	–	189,189
Commercial real estate	66,019	24,729	–	90,748
Other property-related lending	14,408	13,235	–	27,643
Government	1,112	5,818	–	6,930
Other commercial	27,359	31,534	–	58,893
Total corporate and commercial	196,767	176,636	–	373,403
Non-bank financial institutions	13,873	9,795	–	23,668
Settlement accounts	1,092	177	–	1,269
Total financial	14,965	9,972	–	24,937
Gross advances to customers	360,004	309,988	1	669,993
Impairment allowances	(1,991)	(3,357)	–	(5,348)
Net advances to customers	358,013	306,631	1	664,645
2004 (Restated)				
	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>Americas/ Europe</i>	<i>Total</i>
	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>
Residential mortgages	100,068	64,678	–	164,746
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	15,459	–	–	15,459
Other personal	37,164	31,606	7	68,777
Total personal	152,691	96,284	7	248,982
Commercial, industrial and international trade	75,251	95,775	–	171,026
Commercial real estate	55,602	20,963	5	76,570
Other property-related lending	10,520	10,457	–	20,977
Government	2,455	5,081	–	7,536
Other commercial	28,986	27,592	–	56,578
Total corporate and commercial	172,814	159,868	5	332,687
Non-bank financial institutions	12,471	8,048	–	20,519
Settlement accounts	1,423	472	–	1,895
Total financial	13,894	8,520	–	22,414
Gross advances to customers	339,399	264,672	12	604,083
Impairment allowances	(2,942)	(3,462)	(5)	(6,409)
Net advances to customers	336,457	261,210	7	597,674

The geographical information shown above has been classified by the location of the principal operations of the subsidiary company or, in the case of the Bank, by the location of the branch responsible for advancing the funds.

Notes on the Accounts (continued)**15 Advances to customers** (continued)

- c *Analysis of advances to customers by industry sectors based on categories and definitions used by the Hong Kong Monetary Authority.*

The following analysis of advances to customers is based on the categories contained in the 'Quarterly Analysis of Loans and Advances and Provisions' return required to be submitted to the Hong Kong Monetary Authority by branches of the Bank and by banking subsidiary companies in Hong Kong.

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Gross advances to customers for use in				
Hong Kong				
<i>Industrial, commercial and financial</i>				
Property development	41,141	36,230	24,695	23,412
Property investment	104,214	93,696	58,211	48,964
Financial concerns	12,667	14,784	11,696	10,788
Stockbrokers	1,094	1,185	873	871
Wholesale and retail trade	34,256	32,099	28,694	26,639
Manufacturing	17,847	14,336	10,086	9,952
Transport and transport equipment	31,202	35,418	19,178	24,245
Others	44,697	41,134	21,505	17,303
	287,118	268,882	174,938	162,174
<i>Individuals</i>				
Advances for the purchase of flats under				
the Hong Kong SAR Government's				
Home Ownership Scheme, Private				
Sector Participation Scheme and				
Tenants Purchase Scheme	36,291	41,845	13,412	15,450
Advances for the purchase of other				
residential properties	165,148	169,482	83,831	89,504
Credit card advances	29,882	23,162	22,147	16,628
Others	23,826	20,257	15,535	13,135
	255,147	254,746	134,925	134,717
Gross advances to customers for use in				
Hong Kong	542,265	523,628	309,863	296,891
Trade finance	49,902	49,408	34,028	33,869
Gross advances to customers for use outside				
Hong Kong made by branches of the Bank				
and subsidiary companies in Hong Kong	31,989	20,747	16,113	8,639
Gross advances to customers made by				
branches of the Bank and subsidiary				
companies in Hong Kong	624,156	593,783	360,004	339,399
Gross advances to customers made by				
branches of the Bank and subsidiary				
companies outside Hong Kong				
– rest of Asia-Pacific	381,741	333,324	309,988	264,672
– Americas/Europe	5	14	1	12
Gross advances to customers	1,005,902	927,121	669,993	604,083

The categories of advances, and the relevant definitions, used by the Hong Kong Monetary Authority differ from those used for internal purposes by the HSBC Group, including The Hongkong and Shanghai Banking Corporation Limited and its subsidiary companies, as disclosed in Note 15b.

The geographical information shown above has been classified by the location of the principal operations of the subsidiary company or, in the case of the Bank, by the location of the branch responsible for advancing the funds.

15 Advances to customers (continued)

- d Advances to customers include equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases:

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Finance leases	3,809	4,278	3,254	4,207
Hire purchase contracts	29,664	27,045	17,693	16,612
	33,473	31,323	20,947	20,819

Group

	2005			2004		
	<i>Present value of the minimum lease payments</i>	<i>Unearned future finance income</i>	<i>Total minimum lease payments</i>	<i>Present value of the minimum lease payments</i>	<i>Unearned future finance income</i>	<i>Total minimum lease payments</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Amounts receivable						
– within one year	5,324	1,415	6,739	4,796	930	5,726
– after one year but within five years	13,545	3,938	17,483	13,754	2,210	15,964
– after five years	14,648	5,023	19,671	12,840	1,872	14,712
	33,517	10,376	43,893	31,390	5,012	36,402
Impairment allowances	(44)			(67)		
Net investment in finance leases and hire purchase contracts	33,473			31,323		

Bank

	2005			2004		
	<i>Present value of the minimum lease payments</i>	<i>Unearned future finance income</i>	<i>Total minimum lease payments</i>	<i>Present value of the minimum lease payments</i>	<i>Unearned future finance income</i>	<i>Total minimum lease payments</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Amounts receivable						
– within one year	3,996	825	4,821	3,877	716	4,593
– after one year but within five years	9,877	1,947	11,824	10,508	1,475	11,983
– after five years	7,085	1,943	9,028	6,491	772	7,263
	20,958	4,715	25,673	20,876	2,963	23,839
Impairment allowances	(11)			(57)		
Net investment in finance leases and hire purchase contracts	20,947			20,819		

- e The cost of assets acquired during 2005 for leasing to customers under finance leases and hire purchase contracts by the group amounted to HK\$15,308 million (2004: HK\$29,842 million) and by the Bank to HK\$8,849 million (2004: HK\$17,174 million).

Notes on the Accounts (continued)**16 Impairment allowances against advances to customers****a Impairment allowances against advances to customers***Group*

	<i>Individually assessed allowances</i>	<i>Collectively assessed allowances</i>	<i>Country risk allowances</i>	<i>Total</i>
2005	HK\$m	HK\$m	HK\$m	HK\$m
At 1 January (restated)	4,719	3,179	11	7,909
Amounts written off	(1,982)	(1,948)	–	(3,930)
Recoveries of advances written off in previous years	267	395	–	662
Net charge to income statement (Note 4j)	105	1,961	2	2,068
Unwinding of discount of loan impairment	(81)	–	–	(81)
Exchange and other adjustments	(65)	13	–	(52)
At 31 December	<u>2,963</u>	<u>3,600</u>	<u>13</u>	<u>6,576</u>

	<i>Specific Provisions</i>	<i>General Provisions</i>	<i>Total</i>
2004	HK\$m	HK\$m	HK\$m
At 1 January (restated)	8,738	4,138	12,876
Amounts written off	(4,683)	–	(4,683)
Recoveries of advances written off in previous years	617	–	617
Net charge/(release) to income statement (Note 4j)	949	(1,723)	(774)
Exchange and other adjustments	(139)	32	(107)
At 31 December	<u>5,482</u>	<u>2,447</u>	<u>7,929</u>

Bank

	<i>Individually assessed allowances</i>	<i>Collectively assessed allowances</i>	<i>Country risk allowances</i>	<i>Total</i>
2005	HK\$m	HK\$m	HK\$m	HK\$m
At 1 January (restated)	3,866	2,791	11	6,668
Amounts written off	(1,390)	(1,720)	–	(3,110)
Recoveries of advances written off in previous years	194	337	–	531
Net charge/(release) to income statement	(253)	1,592	2	1,341
Unwinding of discount of loan impairment	(61)	–	–	(61)
Exchange and other adjustments	(39)	18	–	(21)
At 31 December	<u>2,317</u>	<u>3,018</u>	<u>13</u>	<u>5,348</u>

	<i>Specific Provisions</i>	<i>General Provisions</i>	<i>Total</i>
2004	HK\$m	HK\$m	HK\$m
At 1 January (restated)	7,234	2,785	10,019
Amounts written off	(3,801)	–	(3,801)
Recoveries of advances written off in previous years	481	–	481
Net charge/(release) to income statement	809	(972)	(163)
Exchange and other adjustments	(144)	17	(127)
At 31 December	<u>4,579</u>	<u>1,830</u>	<u>6,409</u>

16 Impairment allowances against advances to customers (continued)

b Impaired advances to customers and allowances

Group

	<u>Hong Kong</u>	<u>Rest of Asia-Pacific</u>	<u>Americas/ Europe</u>	<u>Total</u>
2005	HK\$m	HK\$m	HK\$m	HK\$m
Impairment provision charge/(release)	1,156	924	(12)	2,068
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	3,920	3,079	–	6,999
Individually assessed allowances	<u>(1,335)</u>	<u>(1,628)</u>	–	<u>(2,963)</u>
	2,585	1,451	–	4,036
Individually assessed allowances as a percentage of gross impaired advances	<u>34.1%</u>	<u>52.9%</u>	–	<u>42.3%</u>
Gross impaired advances as a percentage of gross advances to customers	<u>0.6%</u>	<u>0.8%</u>	–	<u>0.7%</u>
	<u>Hong Kong</u>	<u>Rest of Asia-Pacific</u>	<u>Americas/ Europe</u>	<u>Total</u>
2004	HK\$m	HK\$m	HK\$m	HK\$m
Impairment provision charge/(release)	<u>(1,680)</u>	<u>912</u>	<u>(6)</u>	<u>(774)</u>
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	5,423	4,268	5	9,696
Individually assessed allowances	<u>(2,485)</u>	<u>(2,992)</u>	<u>(5)</u>	<u>(5,482)</u>
	2,938	1,276	–	4,214
Individually assessed allowances as a percentage of gross impaired advances	<u>45.8%</u>	<u>70.1%</u>	<u>100.0%</u>	<u>56.5%</u>
Gross impaired advances as a percentage of gross advances to customers	<u>0.9%</u>	<u>1.3%</u>	<u>35.7%</u>	<u>1.0%</u>

Notes on the Accounts (continued)**16 Impairment allowances against advances to customers** (continued)*Bank*

	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>Americas/ Europe</i>	<i>Total</i>
	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>
2005				
Impairment provision charge/(release)	538	815	(12)	1,341
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	2,402	2,794	–	5,196
Individually assessed allowances	<u>(744)</u>	<u>(1,573)</u>	<u>–</u>	<u>(2,317)</u>
	1,658	1,221	–	2,879
Individually assessed allowances as a percentage of gross impaired advances	31.0%	56.3%	–	44.6%
Gross impaired advances as a percentage of gross advances to customers	0.7%	0.9%	–	0.8%
	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>Americas/ Europe</i>	<i>Total</i>
	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>
2004				
Impairment provision charge/(release)	<u>(905)</u>	<u>748</u>	<u>(6)</u>	<u>(163)</u>
Advances to customers which are considered to be impaired are as follows:				
Gross impaired advances	3,544	3,952	5	7,501
Individually assessed allowances	<u>(1,697)</u>	<u>(2,877)</u>	<u>(5)</u>	<u>(4,579)</u>
	1,847	1,075	–	2,922
Individually assessed allowances as a percentage of gross impaired advances	47.9%	72.8%	100.0%	61.0%
Gross impaired advances as a percentage of gross advances to customers	1.0%	1.5%	41.7%	1.2%

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

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

16 Impairment allowances against advances to customers (continued)

c Overdue advances to customers

Group

	<i>Hong Kong</i>		<i>Rest of Asia-Pacific</i>		<i>Americas/ Europe</i>		<i>Total</i>	
	HK\$m	%	HK\$m	%	HK\$m	%	HK\$m	%
2005								
Gross advances to customers which are overdue with respect to either principal or interest for periods of								
– six months or less but over three months	1,073	0.2	891	0.2	–	–	1,964	0.2
– one year or less but over six months	272	–	430	0.1	–	–	702	0.1
– over one year	1,053	0.2	1,071	0.3	–	–	2,124	0.2
	2,398	0.4	2,392	0.6	–	–	4,790	0.5
2004 (restated)								
Gross advances to customers which are overdue with respect to either principal or interest for periods of:								
– six months or less but over three months	959	0.1	706	0.2	–	–	1,665	0.2
– one year or less but over six months	607	0.1	296	0.1	–	–	903	0.1
– over one year	1,631	0.3	1,430	0.4	–	–	3,061	0.3
	3,197	0.5	2,432	0.7	–	–	5,629	0.6

Notes on the Accounts (continued)**16 Impairment allowances against advances to customers** (continued)*Bank*

	<i>Hong Kong</i>		<i>Rest of Asia-Pacific</i>		<i>Americas/ Europe</i>		<i>Total</i>	
	<i>HK\$m</i>	<i>%</i>	<i>HK\$m</i>	<i>%</i>	<i>HK\$m</i>	<i>%</i>	<i>HK\$m</i>	<i>%</i>
2005								
Gross advances to customers which are overdue with respect to either principal or interest for periods of:								
– six months or less but over three months	591	0.2	675	0.2	–	–	1,266	0.2
– one year or less but over six months	62	–	342	0.1	–	–	404	–
– over one year	816	0.2	981	0.3	–	–	1,797	0.3
	1,469	0.4	1,998	0.6	–	–	3,467	0.5
2004 (restated)								
Gross advances to customers which are overdue with respect to either principal or interest for periods of:								
– six months or less but over three months	371	0.1	530	0.2	–	–	901	0.1
– one year or less but over six months	304	0.1	203	0.1	–	–	507	0.1
– over one year	1,134	0.3	1,269	0.5	–	–	2,403	0.4
	1,809	0.5	2,002	0.8	–	–	3,811	0.6

16 Impairment allowances against advances to customers (continued)

d Rescheduled advances to customers

Group

	<i>Hong Kong</i>		<i>Rest of Asia-Pacific</i>		<i>Americas/ Europe</i>		<i>Total</i>	
	HK\$m	%	HK\$m	%	HK\$m	%	HK\$m	%
2005	1,941	0.3	623	0.2	–	–	2,564	0.3
2004 (restated)	4,009	0.7	465	0.1	5	35.7	4,479	0.5

Bank

	<i>Hong Kong</i>		<i>Rest of Asia-Pacific</i>		<i>Americas/ Europe</i>		<i>Total</i>	
	HK\$m	%	HK\$m	%	HK\$m	%	HK\$m	%
2005	1,580	0.4	602	0.2	–	–	2,182	0.3
2004 (restated)	2,497	0.7	431	0.2	5	41.7	2,933	0.5

Rescheduled advances to customers are those advances which have been restructured or renegotiated because of a deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule.

Rescheduled 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 advances to customers' (Note 16c).

For 2004, rescheduled advances to customers are stated net of interest in suspense and before deduction of specific provisions. For 2005, rescheduled advances to customers are stated gross.

17 Financial investments

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Financial investments				
– which may be repledged or resold by counterparties	1,049	–	1,049	–
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	393,448	–	195,635	–
	394,497	–	196,684	–

Notes on the Accounts (continued)**17 Financial investments** (continued)

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Debt securities		Restated		Restated
– available-for-sale	350,624	–	184,325	–
– held-to-maturity	28,102	443,937	–	270,518
	378,726	443,937	184,325	270,518
Equity shares				
– available-for-sale	15,771	6,228	12,359	3,031
Other financial investments attributable to policyholders under insurance and investment contracts*				
– debt securities at fair value	–	7,196	–	–
– equity shares at fair value	–	14,971	–	–
	–	22,167	–	–
	394,497	472,332	196,684	273,549

* These investments have been transferred to 'Financial assets designated at fair value' following the adoption of HKAS 39.

a Held-to-maturity debt securities*Group*

	<i>Book value</i>		<i>Fair value</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed		Restated		Restated
– listed in Hong Kong	713	16,203	775	16,880
– listed outside Hong Kong	3,274	173,528	3,344	174,313
	3,987	189,731	4,119	191,193
Unlisted	24,115	254,206	23,690	256,512
	28,102	443,937	27,809	447,705
	<i>Book value</i>		<i>Fair value</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Issued by public bodies		Restated		Restated
– central governments and central banks	1,178	105,536	1,215	106,500
– other public sector entities	1,593	40,641	1,729	41,711
	2,771	146,177	2,944	148,211
Issued by other bodies				
– banks	23,550	243,480	23,145	244,665
– corporate entities	1,781	54,280	1,720	54,829
	28,102	443,937	27,809	447,705

17 Financial investments (continued)

Bank

	<i>Book value</i>		<i>Fair value</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed		Restated		Restated
– listed in Hong Kong	–	10,182	–	10,733
– listed outside Hong Kong	–	143,397	–	144,173
	–	153,579	–	154,906
Unlisted	–	116,939	–	117,491
	–	270,518	–	272,397
	<i>Book value</i>		<i>Fair value</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Issued by public bodies		Restated		Restated
– central governments and central banks	–	86,300	–	85,996
– other public sector entities	–	24,925	–	25,362
	–	111,225	–	111,358
Issued by other bodies				
– banks	–	128,136	–	129,606
– corporate entities	–	31,157	–	31,433
	–	270,518	–	272,397

b Available-for-sale debt securities

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed		Restated		Restated
– listed in Hong Kong	6,821	–	3,855	–
– listed outside Hong Kong	89,447	–	87,709	–
	96,268	–	91,564	–
Unlisted	254,356	–	92,761	–
	350,624	–	184,325	–
	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Issued by public bodies		Restated		Restated
– central governments and central banks	61,705	–	47,940	–
– other public sector entities	20,873	–	14,290	–
	82,578	–	62,230	–
Issued by other bodies				
– banks	231,476	–	102,019	–
– corporate entities	36,570	–	20,076	–
	350,624	–	184,325	–

Notes on the Accounts (continued)**17 Financial investments** (continued)**c Available-for-sale equity shares**

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed		Restated		Restated
– listed in Hong Kong	9,930	1,612	8,880	–
– listed outside Hong Kong	2,914	2,071	923	774
	12,844	3,683	9,803	774
Unlisted	2,927	2,545	2,556	2,257
	15,771	6,228	12,359	3,031
Issued by other bodies				
– banks	3,388	1,310	1,581	845
– corporate entities	12,383	4,918	10,778	2,186
	15,771	6,228	12,359	3,031

d Other financial investments attributable to policyholders*(i) Debt securities*

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed		Restated		
– listed in Hong Kong	–	18	–	–
– listed outside Hong Kong	–	1,598	–	–
	–	1,616	–	–
Unlisted	–	5,580	–	–
	–	7,196	–	–
Issued by public bodies				
– central governments and central banks	–	883	–	–
– other public sector entities	–	582	–	–
	–	1,465	–	–
Issued by other bodies				
– banks	–	4,425	–	–
– corporate entities	–	1,306	–	–
	–	7,196	–	–

(ii) Equity shares

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Listed		Restated		
– listed in Hong Kong	–	3,542	–	–
– listed outside Hong Kong	–	8,432	–	–
	–	11,974	–	–
Unlisted	–	2,997	–	–
	–	14,971	–	–
Issued by other bodies				
– banks	–	6,584	–	–
– corporate entities	–	8,387	–	–
	–	14,971	–	–

18 Investments in subsidiary companies

	<i>Bank</i>	
	2005	2004
	HK\$m	HK\$m
		Restated
Investment in subsidiary companies – at cost		
- Unlisted investments	5,383	3,255
- Listed investments	865	865
	6,248	4,120

The principal subsidiary companies of the Bank are:

	<i>Place of incorporation</i>	<i>Principal activity</i>	<i>Issued equity capital</i>	<i>Group's interest in equity capital</i>
Hang Seng Bank Limited	Hong Kong SAR	Banking	HK\$9,559m	62.14%
HSBC Bank Australia Limited*	Australia	Banking	A\$811m	100%
HSBC Insurance (Asia) Limited*	Hong Kong SAR	Insurance	HK\$125m	100%
HSBC Life (International) Limited*	Bermuda	Retirement benefits and life assurance	HK\$327m	100%

* Held indirectly

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

19 Investments in associates

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Unlisted investments	–	–	254	13,864
Listed investments	–	–	16,988	–
Share of net assets	18,799	11,946	–	–
Goodwill	2,303	2,250	–	–
Intangible assets	2,924	3,205	–	–
Deferred tax on intangibles	(965)	(1,058)	–	–
	23,061	16,343	17,242	13,864

a Principal associates

The principal associates of the group are:

	<i>Place of incorporation</i>	<i>Principal activity</i>	<i>Issued equity capital</i>	<i>Group's interest in equity capital</i>
Bank of Communications Limited	People's Republic of China	Banking	RMB45,804m	19.9%
Barrowgate Limited*	Hong Kong SAR	Property investment	1	24.64%
Industrial Bank Co., Ltd.*	People's Republic of China	Banking	RMB3,999m	15.98%

1 Issued equity capital is less than HK\$1 million

* Held indirectly

Notes on the Accounts (continued)**19 Investments in associates** (continued)

The principal countries of operation are the same as the countries of incorporation.

Shareholdings in associated companies include listed investments of HK\$16,988 million (2004: HK\$ nil). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK\$32,130 million.

In respect of the year ended 31 December 2005, Bank of Communications Limited and Industrial Bank Co., Ltd were included based on financial statements drawn up to 30 September 2005, but taking into account any changes in the subsequent period from 1 October 2005 to 31 December 2005 that would materially affect the results. The group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 'Investments in Associates' whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference must be no greater than three months.

Interest in associates includes intangible assets with respect to customer relationships and brand names which are amortised over a period of 10 years.

As allowed by HKFRS 3 in 2005 the goodwill on acquisition of Bank of Communications Limited was finalised. This results in the recognition of intangible assets on acquisition. Comparative figures for 2004 have also been restated.

Hang Seng Bank Limited holds a 15.98 per cent stake in Industrial Bank Co., Ltd. and The Hongkong and Shanghai Banking Corporation Limited holds a 19.9 per cent interest in Bank of Communications Limited. These companies are accounted for as associated companies, as the group has representation on the Board of Directors of each bank, and in accordance with the Technical Support and Assistance Agreements, is assisting in the development of financial and operating policies. In respect of Bank of Communications Limited, a number of staff have been seconded to assist in this process.

In respect of Industrial Bank Co., Ltd., Hang Seng Bank Limited also has representation on the executive committee, whilst for Bank of Communications Limited, the Hongkong and Shanghai Banking Corporation Limited has representation on the senior executive remuneration committee and on the audit committee.

b Summarised aggregate financial information on associates

The group's effective share of associates' financials:

	2005	2004
	HK\$m	HK\$m
Assets	301,517	242,711
Liabilities	283,707	231,483
Revenue	7,153	3,147
Expenses	5,200	2,897
Profit for the year	1,953	250

At 31 December 2005, the group's share of associates contingent liabilities was HK\$52,518 million (2004: HK\$37,623 million).

c Movement in investments in associates

	2005	
	<i>Group</i>	<i>Bank</i>
	HK\$m	HK\$m
At 1 January	16,343	13,864
Additions	3,358	3,351
Disposals	(14)	–
Retained profit	2,035	–
Amortisation of intangible assets (net of deferred tax)	(237)	–
Exchange and other movements	1,576	27
At 31 December	23,061	17,242

There is no impairment of investment in associates.

19 Investments in associates (continued)

d Amounts due from/to associates

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Amounts due from associates	1,722	2,459	1,330	2,127
Amounts due to associates	360	271	350	271

20 Goodwill and intangible assets

‘Goodwill and intangible assets’ includes goodwill arising on business combinations, the present value of in-force long-term assurance business, and other intangible assets.

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Goodwill	1,652	1,473	752	788
Present value of in-force long-term assurance business	4,685	3,513	–	–
Other intangible assets	915	343	819	326
	7,252	5,329	1,571	1,114

a Goodwill

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Cost				
At 1 January	1,473	962	788	322
Additions	10	487	–	469
Transfers	231	–	–	–
Exchange and other movements	(62)	24	(36)	(3)
At 31 December	1,652	1,473	752	788
Net book value at 31 December	1,652	1,473	752	788

There was no impairment of goodwill.

Geographical analysis of goodwill

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Hong Kong	751	522	493	493
Rest of Asia-Pacific	901	951	259	295
	1,652	1,473	752	788

Notes on the Accounts (continued)**20 Goodwill and intangible assets** (continued)**b Present value of in-force long-term assurance business ('PVIF')***(i) PVIF specific assumptions*

The following are the key assumptions used in the computation of PVIF for the main insurance operations:

	2005
Risk free rate	4.19%
Risk adjusted discount rate	11.0%
Expenses inflation	3.0%
Lapse rate	2.0% – 5.0%

(ii) Movement on the PVIF for the year ended 31 December 2005

	<i>Group</i>	
	2005	2004
	HK\$m	HK\$m
At 1 January	3,513	2,667
Addition from current year new business	1,623	1,299
Movement from in-force business	(438)	(466)
Exchange and other adjustments	(13)	13
At 31 December	4,685	3,513

The following table shows the effect on both the PVIF at 31 December 2005 and the new business contribution for the year then ended of hypothetical changes in the main economic assumptions:

	<i>Impact on 2005 results</i>
	HK\$m
+ 100 basis points shift in risk free rate	700
– 100 basis points shift in risk free rate	(776)
+ 100 basis points shift in risk adjusted discount rate	(208)
– 100 basis points shift in risk adjusted discount rate	229
+ 100 basis points shift in expenses inflation	(16)
– 100 basis points shift in expenses inflation	14
+ 100 basis points shift in lapse rate	403
– 100 basis points shift in lapse rate	(427)

20 Goodwill and intangible assets (continued)

c Other intangible assets

Group

	<i>Software</i>	<i>Customer/ merchant relationships</i>	<i>Other</i>	<i>Total</i>
	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>
Cost				
At 1 January 2005	818	119	3	940
Additions	670	–	–	670
Disposals	(17)	–	–	(17)
Transfers	–	60	–	60
Exchange and other movements	(4)	–	2	(2)
At 31 December 2005	<u>1,467</u>	<u>179</u>	<u>5</u>	<u>1,651</u>
Accumulated amortisation and impairment				
At 1 January 2005	(594)	–	(3)	(597)
Amortisation charge for the year	(134)	(24)	–	(158)
Disposals	16	–	–	16
Exchange and other movements	3	–	–	3
At 31 December 2005	<u>(709)</u>	<u>(24)</u>	<u>(3)</u>	<u>(736)</u>
Net book value at 31 December 2005	<u>758</u>	<u>155</u>	<u>2</u>	<u>915</u>
Cost				
	<i>Software</i>	<i>Customer/ merchant relationships</i>	<i>Other</i>	<i>Total</i>
	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>
At 1 January 2004 (restated)	710	–	5	715
Additions	101	119	–	220
Disposals	(4)	–	(2)	(6)
Exchange and other movements	11	–	–	11
At 31 December 2004	<u>818</u>	<u>119</u>	<u>3</u>	<u>940</u>
Accumulated amortisation and impairment				
At 1 January 2004 (restated)	(490)	–	(4)	(494)
Amortisation charge for the year	(100)	–	(1)	(101)
Disposals	3	–	2	5
Exchange and other movements	(7)	–	–	(7)
At 31 December 2004	<u>(594)</u>	<u>–</u>	<u>(3)</u>	<u>(597)</u>
Net book value at 31 December 2004	<u>224</u>	<u>119</u>	<u>–</u>	<u>343</u>

Notes on the Accounts (continued)**20 Goodwill and intangible assets** (continued)*Bank*

	<u>Software</u>	<u>Customer/ merchant relationships</u>	<u>Other</u>	<u>Total</u>
	HK\$m	HK\$m	HK\$m	HK\$m
Cost				
At 1 January 2005	701	119	3	823
Additions	636	–	–	636
Disposals	(15)	–	–	(15)
Exchange and other movements	(4)	–	–	(4)
At 31 December 2005	<u>1,318</u>	<u>119</u>	<u>3</u>	<u>1,440</u>
Accumulated amortisation and impairment				
At 1 January 2005	(494)	–	(3)	(497)
Amortisation charge for the year	(124)	(16)	–	(140)
Disposals	13	–	–	13
Exchange and other movements	3	–	–	3
At 31 December 2005	<u>(602)</u>	<u>(16)</u>	<u>(3)</u>	<u>(621)</u>
Net book value at 31 December 2005	<u>716</u>	<u>103</u>	<u>–</u>	<u>819</u>

	<u>Software</u>	<u>Customer/ merchant relationships</u>	<u>Other</u>	<u>Total</u>
	HK\$m	HK\$m	HK\$m	HK\$m
Cost				
At 1 January 2004 (restated)	600	–	5	605
Additions	93	119	–	212
Disposals	(3)	–	(2)	(5)
Exchange and other movements	11	–	–	11
At 31 December 2004	<u>701</u>	<u>119</u>	<u>3</u>	<u>823</u>
Accumulated amortisation and impairment				
At 1 January 2004 (restated)	(400)	–	(4)	(404)
Amortisation charge for the year	(89)	–	(1)	(90)
Disposals	2	–	2	4
Exchange and other movements	(7)	–	–	(7)
At 31 December 2004	<u>(494)</u>	<u>–</u>	<u>(3)</u>	<u>(497)</u>
Net book value at 31 December 2004	<u>207</u>	<u>119</u>	<u>–</u>	<u>326</u>

There was no impairment on other intangible assets.

The above intangible assets are amortised over their finite useful lives as follows:

Computer software	from 3 years to 5 years
Customer/merchant relationships	from 5 years to 10 years
Other	from 3 years to 5 years

21 Property, plant and equipment

a	<i>Group</i>			<i>Bank</i>		
	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Cost or valuation at 1 January 2005 (restated)	20,642	3,576	11,347	12,925	125	7,660
Exchange and other adjustments	(243)	–	(81)	(247)	–	(58)
Acquisition of subsidiaries	–	–	32	–	–	–
Additions	86	1	1,662	74	–	1,367
Disposals	(916)	(117)	(792)	(811)	–	(587)
Elimination of accumulated depreciation on revalued premises	(605)	–	–	(405)	–	–
Surplus on revaluation	2,818	1,167	–	980	–	–
Reclassifications	161	(154)	(7)	(7)	–	7
At 31 December 2005	21,943	4,473	12,161	12,509	125	8,389
	<i>Group</i>			<i>Bank</i>		
	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Accumulated depreciation at 1 January 2005 (restated)	21	–	8,340	21	–	5,401
Exchange and other adjustments	3	–	(68)	(1)	–	(45)
Charge for the year	631	–	1,194	439	–	889
Acquisition of subsidiaries	–	–	32	–	–	–
Disposals	(7)	–	(769)	(6)	–	(551)
Elimination of accumulated depreciation on revalued premises	(605)	–	–	(405)	–	–
Reclassifications	8	–	(8)	–	–	–
At 31 December 2005	51	–	8,721	48	–	5,694
Net book value at 31 December 2005	21,892	4,473	3,440	12,461	125	2,695
Total at 31 December 2005			29,805			15,281

Notes on the Accounts (continued)

21 Property, plant and equipment (continued)

	<i>Group</i>			<i>Bank</i>		
	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Cost or valuation at 1 January 2004 (restated)	19,640	3,145	10,401	13,218	132	6,913
Exchange and other adjustments	82	–	87	76	–	60
Additions	94	1	1,274	93	–	1,014
Disposals	(490)	(150)	(415)	(374)	–	(327)
Elimination of accumulated depreciation on revalued premises	(646)	–	–	(490)	–	–
Surplus on revaluation	1,921	621	–	402	(7)	–
Reclassifications	41	(41)	–	–	–	–
At 31 December 2004	<u>20,642</u>	<u>3,576</u>	<u>11,347</u>	<u>12,925</u>	<u>125</u>	<u>7,660</u>
	<i>Group</i>			<i>Bank</i>		
	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>	<i>Premises</i>	<i>Investment properties</i>	<i>Equipment</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Accumulated depreciation at 1 January 2004 (restated)	17	–	7,564	16	–	4,860
Exchange and other adjustments	3	–	72	3	–	49
Charge for the year	660	–	1,092	504	–	790
Disposals	(13)	–	(388)	(12)	–	(298)
Elimination of accumulated depreciation on revalued premises	(646)	–	–	(490)	–	–
At 31 December 2004	<u>21</u>	<u>–</u>	<u>8,340</u>	<u>21</u>	<u>–</u>	<u>5,401</u>
Net book value at 31 December 2004	<u>20,621</u>	<u>3,576</u>	<u>3,007</u>	<u>12,904</u>	<u>125</u>	<u>2,259</u>
Total at 31 December 2004			<u>27,204</u>			<u>15,288</u>

b The carrying amount of premises would have been as follows had it been stated at cost less accumulated depreciation:

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Cost less accumulated depreciation	<u>10,740</u>	Restated <u>12,362</u>	<u>8,174</u>	Restated <u>8,973</u>

21 Property, plant and equipment (continued)

c An analysis of premises carried at valuation or cost (before deduction of accumulated depreciation) is as follows:

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Premises carried at valuation	21,745	20,451	12,317	12,734
Other premises stated at cost	198	191	192	191
Premises before deduction of accumulated depreciation	21,943	20,642	12,509	12,925

d The net book value of premises and investment properties comprises:

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
In Hong Kong:				
Long leaseholds (over fifty years)	10,642	9,567	5,307	5,454
Medium-term leaseholds (between ten and fifty years)	12,553	10,926	4,424	4,122
Short leaseholds (less than ten years)	134	–	129	–
	23,329	20,493	9,860	9,576
Outside Hong Kong:				
Freeholds	2,078	2,132	1,952	2,057
Long leaseholds (over fifty years)	61	751	55	745
Medium-term leaseholds (between ten and fifty years)	734	620	559	450
Short leaseholds (less than ten years)	163	201	160	201
	3,036	3,704	2,726	3,453
	26,365	24,197	12,586	13,029
Analysed as follows:				
Premises	21,892	20,621	12,461	12,904
Investment properties	4,473	3,576	125	125
	26,365	24,197	12,586	13,029

The group's premises and investment properties were revalued at 30 September 2005 and updated for any material changes at 31 December 2005. The basis of valuation for premises and investment properties was open market value or, in the case of one specialised property, depreciated replacement cost. In determining the open market value of investment properties, expected future cash flows have been discounted to their present values.

The figures in 2004 have been restated to exclude 'Leasehold land and land use rights' (Note 22) which are now included within 'Prepayments and accrued income' in 'Other assets' (Note 23).

The surplus on property revaluation was HK\$3,985 million (2004 restated : HK\$2,542 million). Amounts of HK\$1,662 million (2004 restated: HK\$464 million) and HK\$1,537 million (2004 restated: HK\$1,656 million) were credited to revaluation reserve and retained profits respectively. The amount credited to the revaluation reserve of HK\$1,662 million (2004 restated: HK\$464 million) is stated after deduction of minority interests of HK\$395 million (2004 restated: HK\$327 million) and deferred tax of HK\$391 million (2004 restated: HK\$95 million).

Premises and investment properties in the Hong Kong SAR, the Macau SAR and the mainland China, representing 95% by value of the group's properties subject to valuation, were valued by DTZ Debenham Tie Leung Limited. The valuations were carried out by qualified valuers who are members of the Hong Kong Institute of Surveyors. Properties in eleven countries, which represent 5% by value of the group's properties, were valued by different independent professionally qualified valuers.

Notes on the Accounts (continued)**21 Property, plant and equipment** (continued)**e Properties leased to customers**

The group's investment properties are rented out under operating leases. The leases typically run for a period of 2-3 years and may contain an option to renew and the terms will then be renegotiated. During the current year, HK\$215 million (2004: HK\$211 million) was recognised as rental income in the income statement in respect of operating leases.

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

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Within one year	184	175	4	4
After one but within five years	87	112	7	–
	271	287	11	4

22 Leasehold land and land use rights

The group's interest in leasehold land and land use rights are accounted for as operating leases and their net book value is analysed as follows:

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
In Hong Kong:				
Leases over fifty years	2,931	2,962	2,502	2,518
Leases of between ten to fifty years	1,116	1,052	103	13
	4,047	4,014	2,605	2,531

The above amounts were included within 'Prepayments and accrued income' in 'Other assets'.

23 Other assets

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
		Restated		Restated
Current taxation recoverable	789	242	698	206
Assets held for sale	601	561	351	235
Prepayments and accrued income	5,038	14,978	4,678	13,886
Accrued interest receivable	10,476	8,338	6,592	5,787
Acceptances and endorsements (Note 29)	22,744	–	20,197	–
Other accounts	8,676	11,645	4,985	8,065
	48,324	35,764	37,501	28,179

Assets held for sale are mainly assets acquired by repossession of collateral for realisation. Under HKAS 39, acceptances and endorsements are recognised on balance sheet with a corresponding liability in 'Other liabilities'. For 2004, they are reported as off-balance sheet commitments.

24 Deposits by banks

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m Restated	2005 HK\$m	2004 HK\$m Restated
Deposits by banks	83,802	74,980	75,674	66,197
Fair value	83,947	75,102	75,819	66,321

25 Customer accounts

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m Restated	2005 HK\$m	2004 HK\$m Restated
Current accounts and demand deposits	925,008	1,069,178	685,622	762,992
Savings accounts	664,478	516,237	437,263	343,158
Other deposit accounts	145,624	142,696	124,194	122,530
	1,735,110	1,728,111	1,247,079	1,228,680
Fair value	1,735,220	1,726,638	1,247,648	1,227,883

26 Trading liabilities

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m Restated	2005 HK\$m	2004 HK\$m Restated
Certificates of deposit in issue	83,937	–	75,008	–
Other debt securities in issue	20,361	–	11,791	–
Short positions in securities	55,025	37,281	34,340	31,439
Deposits by banks	13,488	–	5,063	–
Customer accounts	77,387	–	48,925	–
	250,198	37,281	175,127	31,439

27 Financial liabilities designated at fair value

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Deposits by banks	360	–	359	–
Customer accounts	1,600	–	1,600	–
Subordinated liabilities (Note 33)	967	–	–	–
	2,927	–	1,959	–

28 Debt securities in issue

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m Restated	2005 HK\$m	2004 HK\$m Restated
Certificates of deposit	49,068	110,922	20,139	90,413
Other debt securities	12,400	44,240	1,128	18,000
	61,468	155,162	21,267	108,413
Fair value	61,281	154,024	21,273	108,074

Notes on the Accounts (continued)**29 Other liabilities**

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Provisions for liabilities and charges (Note 32)	938	826	803	652
Obligations under finance leases	5	7	3	5
Dividend payable	796	796	–	–
Accruals and deferred income	12,418	26,262	9,443	22,728
Acceptances and endorsements (Note 23)	22,744	–	20,197	–
Other liabilities	9,727	9,267	7,244	6,350
	46,628	37,158	37,690	29,735

Obligations under finance leases falling due:

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Present value of the minimum lease payments				
– within 1 year	1	1	–	–
– between 1 and 5 years	4	6	3	5
	5	7	3	5

Interest expense relating to future periods are insignificant.

30 Liabilities under insurance contracts issued*Group*

	2005		
	Gross	Reinsurance	Net
	HK\$m	HK\$m	HK\$m
Non-life insurance			
Unearned premiums	713	(109)	604
Outstanding claims	1,189	(317)	872
Claims incurred but not reported	292	(60)	232
Provision for unexpired risk	15	–	15
Other	193	(77)	116
Total non-life	2,402	(563)	1,839
Policyholder liabilities			
Life (non-linked)	32,646	(13)	32,633
Investment contracts with discretionary participation features	72	–	72
Life (linked)	6,725	(1)	6,724
	39,443	(14)	39,429
Total liabilities under insurance contracts	41,845	(577)	41,268

30 Liabilities under insurance contracts issued (continued)

	2004		
	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
Non-life insurance			
Unearned premiums	647	(128)	519
Outstanding claims	1,206	(379)	827
Claims incurred but not reported	389	(89)	300
Provision for unexpired risk	3	–	3
Other	72	(74)	(2)
Total non-life	<u>2,317</u>	<u>(670)</u>	<u>1,647</u>
Policyholder liabilities			
Life (non-linked)	18,134	(13)	18,121
Life (linked)	5,971	–	5,971
	<u>24,105</u>	<u>(13)</u>	<u>24,092</u>
Total liabilities under insurance contracts	<u>26,422</u>	<u>(683)</u>	<u>25,739</u>

a General economic and business assumptions

The key assumptions about the future and other sources of measurement uncertainty, that have a significant risk of causing material adjustments to the carrying amounts of insurance liabilities within the next financial year are:

	Movement	Impact on 2005 results	
		Profit for the year HK\$m	Net assets HK\$m
Economic assumptions			
Exchange rate with USD	-20%	(73)	(73)
Claims cost inflation	+20%	(29)	(29)
Claims cost inflation	-20%	29	29
Non-economic assumptions			
Mortality and/or morbidity	+10%	(97)	(97)
Mortality and/or morbidity	-10%	97	97
Lapse rate	+50%	287	287
Lapse rate	-50%	(247)	(247)
Expense rate	+10%	(75)	(75)
Expense rate	-10%	69	69

Notes on the Accounts (continued)**30 Liabilities under insurance contracts issued** (continued)**b Movement of liabilities under insurance contracts***(i) Non-life insurance*

	2005		
	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
Unearned premiums			
At 1 January	647	(128)	519
Gross written premiums	2,009	(397)	1,612
Gross earned premiums	(1,955)	412	(1,543)
Exchange and other movements	12	4	16
At 31 December	<u>713</u>	<u>(109)</u>	<u>604</u>
Notified and incurred but not reported claims			
At 1 January			
– Notified claims	1,206	(379)	827
– Claims incurred but not reported	389	(89)	300
	1,595	(468)	1,127
Claims paid in current year	(713)	96	(617)
Claims incurred	607	(10)	597
Exchange and other movements	(8)	5	(3)
At 31 December			
– Notified claims	1,189	(317)	872
– Claims incurred but not reported	292	(60)	232
Total at 31 December	<u>1,481</u>	<u>(377)</u>	<u>1,104</u>
	2004		
	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
Unearned premiums			
At 1 January	646	(148)	498
Gross written premiums	1,941	(423)	1,518
Gross earned premiums	(1,934)	442	(1,492)
Exchange and other movements	(6)	1	(5)
At 31 December	<u>647</u>	<u>(128)</u>	<u>519</u>
Notified and incurred but not reported claims			
At 1 January			
– Notified claims	1,127	(385)	742
– Claims incurred but not reported	421	(75)	346
	1,548	(460)	1,088
Claims paid in current year	(771)	159	(612)
Claims incurred	809	(160)	649
Exchange and other movements	9	(7)	2
At 31 December			
– Notified claims	1,206	(379)	827
– Claims incurred but not reported	389	(89)	300
Total at 31 December	<u>1,595</u>	<u>(468)</u>	<u>1,127</u>

30 Liabilities under insurance contracts issued (continued)

(ii) Policyholder liabilities

	2005		
	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
Life (non-linked)			
At 1 January	18,134	(13)	18,121
Benefits paid	(460)	32	(428)
Claims incurred	14,868	(31)	14,837
Exchange and other movements	104	(1)	103
At 31 December	<u>32,646</u>	<u>(13)</u>	<u>32,633</u>
Investment contracts with discretionary participation features			
At 1 January	–	–	–
Claims incurred	70	–	70
Exchange and other movements	2	–	2
At 31 December	<u>72</u>	<u>–</u>	<u>72</u>
Life (linked)			
At 1 January	5,971	–	5,971
Benefits paid	(1,071)	2	(1,069)
Claims incurred	1,812	(3)	1,809
Exchange and other movements	13	–	13
At 31 December	<u>6,725</u>	<u>(1)</u>	<u>6,724</u>
Total policyholder liabilities	<u>39,443</u>	<u>(14)</u>	<u>39,429</u>
2004			
	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
Life (non-linked)			
At 1 January	9,762	(12)	9,750
Benefits paid	(247)	26	(221)
Claims incurred	8,445	(27)	8,418
Exchange and other movements	174	–	174
At 31 December	<u>18,134</u>	<u>(13)</u>	<u>18,121</u>
Life (linked)			
At 1 January	3,479	–	3,479
Benefits paid	(253)	5	(248)
Claims incurred	2,702	(5)	2,697
Exchange and other movements	43	–	43
At 31 December	<u>5,971</u>	<u>–</u>	<u>5,971</u>
Total policyholder liabilities	<u>24,105</u>	<u>(13)</u>	<u>24,092</u>

Notes on the Accounts (continued)**31 Deferred taxation**

The components of deferred tax (assets)/liabilities recognised in the balance sheet and the movements during the year are as follows:

Group

	<i>Accelerated capital Allowances and short- term timing differences</i>	<i>Leasing transactions</i>	<i>Impairment losses on financial assets</i>	<i>Revaluation of properties</i>	<i>Others</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
2005						
At 1 January						
– as previously reported	(72)	382	(841)	2,007	208	1,684
– arising on adoption of HKAS 39	(33)	–	39	–	167	173
– as restated	(105)	382	(802)	2,007	375	1,857
Exchange and other adjustments	(31)	(91)	234	25	193	330
Charge/(credit) to income statement (Note 5)	227	8	(19)	225	38	479
Transfer between reserves	–	–	–	431	(640)	(209)
At 31 December	91	299	(587)	2,688	(34)	2,457
2004						
At 1 January (restated)	224	535	(1,049)	1,736	(360)	1,086
Exchange and other adjustments	(19)	(95)	(5)	31	(22)	(110)
Charge/(credit) to income statement (Note 5)	(277)	(58)	213	87	544	509
Transfer between reserves	–	–	–	153	46	199
At 31 December	(72)	382	(841)	2,007	208	1,684

31 Deferred taxation (continued)

Bank

	<i>Accelerated capital allowances and short- term timing differences</i>	<i>Leasing transactions</i>	<i>Impairment losses on financial assets</i>	<i>Revaluation of properties</i>	<i>Others</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
2005						
At 1 January						
– as previously reported	(42)	304	(649)	810	(138)	285
– arising on adoption of HKAS 39	(72)	–	(43)	–	(60)	(175)
– as restated	(114)	304	(692)	810	(198)	110
Exchange and other adjustments	11	(43)	229	(33)	170	334
Charge/(credit) to income statement	413	(3)	26	13	(209)	240
Transfer between reserves	–	–	–	162	(390)	(228)
At 31 December	310	258	(437)	952	(627)	456
2004						
At 1 January (as restated)	126	425	(741)	787	(127)	470
Exchange and other adjustments	(22)	(63)	1	32	(23)	(75)
Charge/(credit) to income statement	(146)	(58)	91	143	(29)	1
Transfer between reserves	–	–	–	(152)	41	(111)
At 31 December	(42)	304	(649)	810	(138)	285

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Net deferred tax liability recognised on the balance sheet	3,729	3,395	1,238	1,405
Net deferred tax asset recognised on the balance sheet	(1,272)	(1,711)	(782)	(1,120)
	2,457	1,684	456	285

There is no significant deferred taxation liability not provided for.

At 31 December 2005, there were unrecognised potential future tax benefits of approximately HK\$697 million (2004 : HK\$706 million) mainly in respect of tax losses which are considered unlikely to be utilised.

Notes on the Accounts (continued)**32 Provisions for liabilities and charges***Group*

	<i>Provisions for contingent liabilities and commitments</i>	<i>Other provisions</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m
2005			
At 1 January			
– as previously reported	693	133	826
– arising on adoption of HKAS 39	(59)	–	(59)
– as restated	634	133	767
Net charge to income statement	309	60	369
Provisions utilised	(15)	(84)	(99)
Exchange and other movements	(100)	1	(99)
At 31 December	828	110	938
2004			
At 1 January	802	263	1,065
Net charge to income statement	43	323	366
Provisions utilised	(232)	(440)	(672)
Exchange and other movements	80	(13)	67
At 31 December	693	133	826

Bank

	<i>Provisions for contingent liabilities and commitments</i>	<i>Other provisions</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m
2005			
At 1 January			
– as previously reported	535	117	652
– arising on adoption of HKAS 39	(59)	–	(59)
– as restated	476	117	593
Net charge to income statement	329	47	376
Provisions utilised	(9)	(62)	(71)
Exchange and other movements	(91)	(4)	(95)
At 31 December	705	98	803
2004			
At 1 January	517	246	763
Net charge to income statement	121	315	436
Provisions utilised	(173)	(431)	(604)
Exchange and other movements	70	(13)	57
At 31 December	535	117	652

33 Subordinated liabilities

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

		2005	2004
		HK\$m	HK\$m
US\$1,200m	Primary capital subordinated undated floating rate notes*	9,359	9,328
Rs 2,000m	Fixed rate (13.05%) subordinated loans 2009	344	358
<i>Total Bank</i>		9,703	9,686
A\$70m	Subordinated floating rate notes callable quarterly from 2007 to 2011	398	425
A\$100m	Subordinated fixed rate (6.5%) until 2006 and floating thereafter, callable quarterly to 2011	568	607
A\$70m	Subordinated floating rate notes callable quarterly from 2007 to 2012	397	424
HK\$1,500m	Callable floating rate subordinated notes due 2015	1,495	–
<i>Total Group</i>		12,561	11,142
Fair value			
– Bank		8,807	9,378
– Group		11,607	10,773

* US\$800 million of this subordinated capital is subject to an interest rate floor of 5%.

The following subordinated note was classified as 'Financial liabilities designated at fair value' (Note 27):

		<i>Group</i>	
		2005	2004
		HK\$m	HK\$m
HK\$1,000m	Callable fixed rate (4.125%) subordinated notes due 2015	967	–

34 Preference shares

Authorised

At 31 December 2005, the authorised preference share capital of the Bank was US\$9,700,500,000 (2004: US\$7,500,500,000) comprising 500,000 cumulative redeemable preference shares of US\$1 each, 7,500 million non-cumulative irredeemable preference shares of US\$1 each and 2,200 million cumulative irredeemable preference shares of US\$1 each (2004: comprising 500,000 cumulative redeemable preference shares of US\$1 each and 7,500 million non-cumulative irredeemable preference shares of US\$1 each).

Issued and fully paid

	<i>Bank and Group</i>	
	2005	2004
	HK\$m	HK\$m
Redeemable preference shares	4	4
Irredeemable preference shares	68,103	51,715
Share premium	3,873	3,883
	71,980	55,602
Fair value	72,769	56,740

Notes on the Accounts (continued)**34 Preference shares** (continued)

The cumulative redeemable preference shares have a mandatory redemption date of 2 January 2019 but may be redeemed at the Bank's option on or after 2 January 2003, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US\$1,000 per share, comprising nominal value of US\$1 per share and premium on issue of US\$999 per share. The number of issued cumulative redeemable preference shares at 31 December 2005 was 500,000 (2004: 500,000).

The non-cumulative irredeemable preference shares are issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. On redemption, holders of the shares shall be entitled to receive the issue price of US\$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of redemption, subject to the Bank having sufficient distributable profits. The number of issued non-cumulative irredeemable preference shares at 31 December 2005 was 6,653 million (2004: 6,653 million). No shares were issued during the year (2004: 2,100 million).

The cumulative irredeemable preference shares are issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. On redemption, holders of the shares shall be entitled to receive the issue price of US\$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of redemption, subject to the Bank having sufficient distributable profits. The number of issued cumulative irredeemable preference shares at 31 December 2005 was 2,130 million (2004: nil). 2,130 million shares were issued during the year (2004: nil).

35 Share capital*Authorised*

The authorised ordinary share capital of the Bank at 31 December 2005 and 31 December 2004 was HK\$30,000 million divided into 12,000 million ordinary shares of HK\$2.50 each.

Issued and fully paid

	<i>Bank and Group</i>	
	2005	2004
	HK\$m	HK\$m
Ordinary share capital	22,494	22,494

No new shares were issued during 2005.

36 Reserves

2005	<i>Group</i> HK\$m	<i>Bank</i> HK\$m	<i>Associates</i> HK\$m
Share premium account			
At 1 January 2005			
– Balance previously reported	3,883	3,883	–
– Effect of transition to HKFRS	(3,883)	(3,883)	–
– As restated	–	–	–
At 31 December 2005	–	–	–
	<i>Group</i> HK\$m	<i>Bank</i> HK\$m	<i>Associates</i> HK\$m
Other reserves			
<i>Property revaluation reserve</i>			
At 1 January 2005			
– Balance previously reported	11,907	1,884	381
– Effect of transition to HKFRS	(8,842)	(1,884)	(381)
– As restated	3,065	–	–
Unrealised surplus on revaluation	2,053	779	–
Transfer of depreciation from retained profits	(173)	(92)	–
Realisation on disposal of properties	(523)	(463)	–
Deferred tax and other movements	(340)	(152)	–
At 31 December 2005	4,082	72	–
<i>Available-for-sale investment reserve</i>			
At 1 January 2005			
– Balance previously reported	–	–	–
– Effect on adoption of HKAS 39	3,257	1,710	–
– As restated	3,257	1,710	–
Fair value losses taken to equity	(1,317)	(907)	–
Transfer to income statement on disposal	(587)	(300)	–
Transfer to income statement on change in fair value of hedged items	983	806	–
Share of associates' available-for-sale reserve	557	–	557
Deferred tax and other movements	6	35	(28)
At 31 December 2005	2,899	1,344	529
<i>Long-term equity investment revaluation reserve</i>			
At 1 January 2005			
– Balance previously reported	1,609	513	–
– Effect of transition to HKFRS (excluding HKAS 39)	190	165	–
– As restated	1,799	678	–
– Effect on adoption of HKAS 39	(1,799)	(678)	–
– As restated	–	–	–
At 31 December 2005	–	–	–
<i>Cash flow hedge reserve</i>			
At 1 January 2005			
– Balance previously reported	–	–	–
– Effect on adoption of HKAS 39	(125)	(117)	–
– As restated	(125)	(117)	–
Fair value losses taken to equity	(2,522)	(2,232)	–
Amounts transferred to income statement	538	534	–
Deferred tax and other movements	342	287	–
At 31 December 2005	(1,767)	(1,528)	–

Notes on the Accounts (continued)

36 Reserves (continued)

	<u>Group</u> HK\$m	<u>Bank</u> HK\$m	<u>Associates</u> HK\$m
<i>Reserves arising from the revaluation of subsidiary and associates to fair value</i>			
At 1 January 2005			
– Balance previously reported	–	129,430	–
– Change in accounting policy	–	(129,430)	–
– As restated	–	–	–
At 31 December 2005	–	–	–
<i>Foreign exchange reserve</i>			
At 1 January 2005			
– Balance previously reported	–	–	–
– Effect of transition to HKFRS	843	819	–
– As restated	843	819	–
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	(790)	(383)	–
At 31 December 2005	53	436	–
<i>Other</i>			
At 1 January 2005			
– Balance previously reported	–	–	–
– Effect of transition to HKFRS	322	244	–
– As restated	322	244	–
Employees' options granted cost free by ultimate holding company	307	232	–
Exchange and other movements	141	(14)	18
At 31 December 2005	770	462	18
Total other reserves	6,037	786	547
Retained profits			
At 1 January 2005			
– Balance previously reported	51,083	34,245	252
– Effect of transition to HKFRS (excluding HKAS 39)	(599)	(11,119)	583
– As restated	50,484	23,126	835
– Effect on adoption of HKAS 39	(39)	(943)	(241)
– As restated	50,445	22,183	594
Profit for the year attributable to shareholders	32,873	27,578	1,905
Dividends	(20,300)	(20,300)	–
Transfer of depreciation to property revaluation reserves	173	92	–
Realisation on disposal of properties	523	463	–
Actuarial gains/(losses) on defined benefit plans	73	(17)	–
Deferred tax and other movements	516	(3)	297
At 31 December 2005	64,303	29,996	2,796
Total reserves at 31 December 2005	70,340	30,782	3,343

36 Reserves (continued)

	<u>Group</u>	<u>Bank</u>	<u>Associates</u>
	HK\$m	HK\$m	HK\$m
2004			
Share premium account			
At 1 January 2004			
– Balance previously reported	3,878	3,878	–
– Effect of transition to HKFRS	<u>(3,878)</u>	<u>(3,878)</u>	<u>–</u>
– As restated	<u>–</u>	<u>–</u>	<u>–</u>
At 31 December 2004	<u>–</u>	<u>–</u>	<u>–</u>
	<u>Group</u>	<u>Bank</u>	<u>Associates</u>
	HK\$m	HK\$m	HK\$m
Other reserves			
<i>Property revaluation reserve</i>			
At 1 January 2004			
– Balance previously reported	7,135	–	285
– Effect of transition to HKFRS	<u>(4,817)</u>	<u>–</u>	<u>(285)</u>
– As restated	<u>2,318</u>	<u>–</u>	<u>–</u>
Unrealised surplus/(deficit) on revaluation	559	(478)	–
Transfer of depreciation from retained profits	(157)	(108)	–
Realisation on disposal of properties	(417)	(347)	–
Transfer from retained profits	876	876	–
Deferred tax and other movements	<u>(114)</u>	<u>57</u>	<u>–</u>
At 31 December 2004	<u>3,065</u>	<u>–</u>	<u>–</u>
<i>Long-term equity investment revaluation reserve</i>			
At 1 January 2004			
– Balance previously reported	1,182	563	–
– Effect of transition to HKFRS	<u>83</u>	<u>64</u>	<u>–</u>
– As restated	<u>1,265</u>	<u>627</u>	<u>–</u>
Surplus on revaluation	1,610	564	–
Realisation on disposal of investments	(1,033)	(528)	–
Deferred tax and other movements	<u>(43)</u>	<u>15</u>	<u>–</u>
At 31 December 2004	<u>1,799</u>	<u>678</u>	<u>–</u>
<i>Reserves arising from the revaluation of subsidiary and associates to fair value</i>			
At 1 January 2004			
– Balance previously reported	–	117,533	–
– Change in accounting policy	<u>–</u>	<u>(117,533)</u>	<u>–</u>
– As restated	<u>–</u>	<u>–</u>	<u>–</u>
At 31 December 2004	<u>–</u>	<u>–</u>	<u>–</u>
<i>Foreign exchange reserve</i>			
At 1 January 2004	–	–	–
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	<u>843</u>	<u>819</u>	<u>–</u>
At 31 December 2004	<u>843</u>	<u>819</u>	<u>–</u>

Notes on the Accounts (continued)**36 Reserves** (continued)

	<u>Group</u> HK\$m	<u>Bank</u> HK\$m	<u>Associates</u> HK\$m
<i>Other</i>			
At 1 January 2004			
– Balance previously reported	–	–	–
– Effect of transition to HKFRS	98	75	–
– As restated	98	75	–
Employees' options granted cost free by ultimate holding company	224	169	–
At 31 December 2004	<u>322</u>	<u>244</u>	–
Total other reserves	<u>6,029</u>	<u>1,741</u>	–
Retained profits			
At 1 January 2004			
– Balance previously reported	37,764	23,937	537
– Effect of transition to HKFRS	1,235	(9,172)	294
– As restated	38,999	14,765	831
Profit for the year attributable to shareholders	32,148	29,405	300
Dividends	(20,300)	(20,300)	–
Transfer of depreciation to property revaluation reserves	157	108	–
Transfer to property revaluation reserve	(876)	(876)	–
Realisation on disposal of properties	417	347	(547)
Actuarial losses on defined benefit plans	(453)	(288)	–
Deferred tax and other movements	392	(35)	9
At 31 December 2004	<u>50,484</u>	<u>23,126</u>	<u>593</u>
Total reserves at 31 December 2004	<u>56,513</u>	<u>24,867</u>	<u>593</u>

The Bank and its banking subsidiary companies operate under regulatory jurisdictions which require the maintenance of minimum impairment provisions in excess of those required under Hong Kong Accounting Standards. At 31 December 2005, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK\$1,319 million.

37 Maturity analysis of assets and liabilities

The following is an analysis of assets and liabilities by remaining contractual maturities at the balance sheet date:

Group	On demand	Due	Due	Due	Due	No contractual maturity	Trading	Non-	Total
		within 3 months	between 3 and 12 months	between 1 and 5 years	after 5 years		instruments	trading derivatives	
2005	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Assets	178,227	276,086	47,771	646	—	—	—	—	502,730
Cash and short-term funds	—	26,298	37,692	2,606	2,958	—	—	—	69,554
Placings with banks maturing after one month	—	—	—	—	—	—	—	—	—
Items in the course of collection from other banks	—	17,782	—	—	—	—	—	—	17,782
Certificates of deposit	—	18,092	15,673	17,752	2,314	—	—	—	53,831
Hong Kong SAR Government certificates of indebtedness	97,344	—	—	—	—	—	—	—	97,344
Trading assets	—	—	—	—	—	—	215,681	—	215,681
Financial assets designated at fair value	—	2,723	4,268	9,073	2,355	18,654	—	—	37,073
Derivatives	—	—	—	—	—	—	69,647	2,392	72,039
Advances to customers	71,364	193,525	145,863	305,938	282,636	—	—	—	999,326
Financial investments	—	42,238	72,084	214,649	50,128	15,398	—	—	394,497
Amounts due from fellow subsidiary companies	—	94,885	6,231	57	—	—	—	—	101,173
Investments in associates	—	—	—	—	—	23,061	—	—	23,061
Goodwill and intangible assets	—	—	—	—	—	7,252	—	—	7,252
Property, plant and equipment	—	—	—	—	—	29,805	—	—	29,805
Deferred tax assets	—	—	—	—	—	1,272	—	—	1,272
Retirement benefit assets	—	—	—	—	—	1,788	—	—	1,788
Other assets	4,100	30,858	6,345	828	5	6,188	—	—	48,324
Total assets at 31 December 2005	351,035	702,487	335,927	551,549	340,396	103,418	285,328	2,392	2,672,532
Total assets at 31 December 2004	287,033	703,132	308,658	587,298	305,337	59,816	235,541	—	2,486,815

Notes on the Accounts (continued)

Liabilities	On demand	Due within 3 months	Due between 3 and 12 months	Due between 1 and 5 years	Due after 5 years	No contractual maturity	Trading instruments	Non-trading derivatives	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Hong Kong SAR currency notes in circulation	97,344	—	—	—	—	—	—	—	97,344
Deposits by banks	36,649	39,139	6,339	1,590	85	—	—	—	83,802
Customer accounts	1,026,453	635,437	58,656	11,970	2,594	—	—	—	1,735,110
Items in the course of transmission to other banks	—	20,927	—	—	—	—	—	—	20,927
Trading liabilities	—	—	—	—	—	—	250,198	—	250,198
Financial liabilities designated at fair value	—	—	—	115	2,839	(27)	—	—	2,927
Derivatives	—	—	—	—	—	—	70,180	1,829	72,009
Debt securities in issue	—	23,038	18,666	19,712	50	2	—	—	61,468
Retirement benefit liabilities	—	—	—	—	—	394	—	—	394
Amounts due to fellow subsidiary companies	—	17,774	3,109	1,392	—	—	—	—	22,275
Amounts due to ultimate holding company	—	396	—	—	2,106	—	—	—	2,502
Other liabilities	2,657	27,206	4,931	510	—	11,324	—	—	46,628
Liabilities to customers under investment contracts	—	—	—	323	—	30,041	—	—	30,364
Liabilities under insurance contracts issued	—	—	—	—	—	41,845	—	—	41,845
Current taxation	371	723	950	—	—	—	—	—	2,044
Deferred taxation	—	—	—	—	—	3,729	—	—	3,729
Subordinated liabilities	—	—	—	344	2,858	9,359	—	—	12,561
Preference shares	—	—	—	—	3,877	68,103	—	—	71,980
Total liabilities at 31 December 2005	1,163,474	764,640	92,651	35,956	14,409	164,770	320,378	1,829	2,558,107
Total liabilities at 31 December 2004	1,355,498	517,694	100,498	111,223	27,490	144,651	129,644	—	2,386,698

37 Maturity analysis of assets and liabilities (continued)

Bank

2005 Assets	On demand	Due within 3 months	Due between 3 and 12 months	Due between 1 and 5 years	Due after 5 years	No contractual maturity	Trading instruments	Non- trading derivatives	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Cash and short-term funds	151,225	230,487	47,771	646	—	—	—	—	430,129
Placings with banks maturing after one month	—	15,170	32,671	2,406	2,958	—	—	—	53,205
Items in the course of collection from other banks	—	9,705	—	—	—	—	—	—	9,705
Certificates of deposit	—	13,507	5,864	2,923	707	—	—	—	23,001
Hong Kong SAR Government certificates of indebtedness	97,344	—	—	—	—	—	173,169	—	97,344
Trading assets	—	—	—	—	—	—	—	—	173,169
Financial assets designated at fair value	—	1,883	2,685	3,004	1,102	81	—	—	8,755
Derivatives	—	—	—	—	—	—	68,541	1,787	70,328
Advances to customers	47,160	156,201	102,713	189,909	168,662	—	—	—	664,645
Financial investments	—	34,201	41,138	83,015	26,288	12,042	—	—	196,684
Amounts due from subsidiary companies	—	10,115	2,558	1,166	9,732	—	—	—	23,571
Amounts due from fellow subsidiary companies	—	90,118	6,231	57	—	—	—	—	96,406
Investments in subsidiary companies	—	—	—	—	—	6,248	—	—	6,248
Investments in associates	—	—	—	—	—	17,242	—	—	17,242
Goodwill and intangible assets	—	—	—	—	—	1,571	—	—	1,571
Property, plant and equipment	—	—	—	—	—	15,281	—	—	15,281
Deferred tax assets	—	—	—	—	—	782	—	—	782
Retirement benefit assets	—	—	—	—	—	1,252	—	—	1,252
Other assets	3,277	24,716	5,541	781	—	3,186	—	—	37,501
Total assets at 31 December 2005	299,006	586,103	247,172	283,907	209,449	57,685	241,710	1,787	1,926,819
Total assets at 31 December 2004	243,118	584,902	223,848	333,577	182,729	43,873	203,393	—	1,815,440

Notes on the Accounts (continued)

37 Maturity analysis of assets and liabilities (continued)

Liabilities	On demand HK\$m	Due within 3 months HK\$m	Due between 3 and 12 months HK\$m	Due between 1 and 5 years HK\$m	Due after 5 years HK\$m	No contractual maturity HK\$m	Trading instruments HK\$m	Non- trading derivatives HK\$m	Total HK\$m
Hong Kong SAR currency notes in circulation	97,344	–	–	–	–	–	–	–	97,344
Deposits by banks	34,965	32,703	6,331	1,590	85	–	–	–	75,674
Customer accounts	763,441	423,606	46,830	10,558	2,644	–	–	–	1,247,079
Items in the course of transmission to other banks	–	14,317	–	–	–	–	–	–	14,317
Trading liabilities	–	–	–	–	–	–	175,127	–	175,127
Financial liabilities designated at fair value	–	–	–	115	1,844	–	–	–	1,959
Derivatives	–	–	–	–	–	–	70,101	1,309	71,410
Debt securities in issue	–	12,839	7,380	1,048	–	–	–	–	21,267
Retirement benefit liabilities	–	–	–	–	–	379	–	–	379
Amounts due to subsidiary companies	–	12,102	217	2,616	5,838	–	–	–	20,773
Amounts due to fellow subsidiary companies	–	14,669	3,108	1,392	–	–	–	–	19,169
Amounts due to ultimate holding company	–	371	–	–	2,106	–	–	–	2,477
Other liabilities	2,500	21,612	4,691	472	–	8,415	–	–	37,690
Current taxation	–	714	743	–	–	–	–	–	1,457
Deferred taxation	–	–	–	–	–	1,238	–	–	1,238
Subordinated liabilities	–	–	–	344	–	9,359	–	–	9,703
Preference shares	–	–	–	–	3,877	68,103	–	–	71,980
Total liabilities at									
31 December 2005	898,250	532,933	69,300	18,135	16,394	87,494	245,228	1,309	1,869,043
Total liabilities at 31 December 2004	1,014,436	359,384	69,447	93,649	27,047	77,397	121,919	–	1,763,279

38 Interest rate analysis of financial instruments

The table below discloses the mismatch of the dates on which interest rates on financial assets and financial liabilities are next reset to market rate on a contractual basis, or if earlier, the dates on which the instruments mature, as at 31 December 2005. Actual reset dates may differ from contractual dates owing to prepayments and the exercise of options. In addition, contractual terms may not be representative of the behaviour of financial assets and liabilities. For these reasons, the group manages its risk on the basis of the behaviour of the relevant financial assets and liabilities. Interest rate risk on trading assets is covered by Note 50.

Group	Up to 3 months		3 to 6 months		6 to 12 months		1 to 5 years		Over 5 years		Non-interest bearing		Total non-trading		Designated at fair value		Trading		Total		Effective interest rate	
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m		
2005																						
Financial assets																						
Treasury bills	58,033	19,815	27,032	572	–	–	–	–	–	–	–	–	105,452	94	69,880	175,426	3.00%					
Loans and advances to banks	354,813	19,729	20,944	157	1,615	16,034	413,292	–	–	–	–	–	413,292	–	3,624	416,916	2.99%					
Loans and advances to customers	866,998	53,567	26,255	27,896	21,850	2,760	999,326	3,589	10,813	1,013,728	–	999,326	3,589	10,813	1,013,728	4.90%						
Debt securities	208,424	31,824	43,798	110,898	36,802	811	432,557	15,070	108,687	556,314	–	432,557	15,070	108,687	556,314	3.57%						
Other assets	91,346	–	–	–	–	377,805	469,151	18,320	–	–	–	469,151	18,320	22,677	510,148	2.70%						
	<u>1,579,614</u>	<u>124,935</u>	<u>118,029</u>	<u>139,523</u>	<u>60,267</u>	<u>397,410</u>	<u>2,419,778</u>	<u>37,073</u>	<u>215,681</u>	<u>2,672,532</u>	<u>–</u>	<u>2,419,778</u>	<u>37,073</u>	<u>215,681</u>	<u>2,672,532</u>	<u>3.95%</u>						
Financial liabilities																						
Deposits by banks	63,020	2,101	4,233	–	–	–	–	–	–	–	–	–	83,802	360	13,488	97,650	3.34%					
Customer accounts	1,518,153	36,927	22,259	10,253	768	177,114	1,765,474	1,600	77,387	1,844,461	–	1,765,474	1,600	77,387	1,844,461	1.78%						
Debt securities in issue	35,135	8,266	4,105	13,912	50	–	61,468	–	–	165,766	–	61,468	–	104,298	165,766	4.55%						
Other liabilities	17,671	–	–	5	–	–	292,021	309,697	–	364,722	–	309,697	–	55,025	364,722	0.86%						
Subordinated liabilities	11,649	–	568	344	–	–	12,561	967	–	13,528	–	12,561	967	–	13,528	4.93%						
Preference shares	20,160	16,853	34,967	–	–	–	71,980	–	–	71,980	–	71,980	–	–	71,980	4.75%						
	<u>1,665,788</u>	<u>64,147</u>	<u>66,132</u>	<u>24,514</u>	<u>818</u>	<u>483,583</u>	<u>2,304,982</u>	<u>2,927</u>	<u>250,198</u>	<u>2,558,107</u>	<u>–</u>	<u>2,304,982</u>	<u>2,927</u>	<u>250,198</u>	<u>2,558,107</u>	<u>2.06%</u>						
Off-balance sheet	139,458	24,720	32,625	(10,636)	–	–	186,167	–	–	186,167	–	–	–	–	–	186,167	–					
Interest rate sensitivity gap	<u>53,284</u>	<u>85,508</u>	<u>84,522</u>	<u>104,373</u>	<u>59,449</u>	<u>(86,173)</u>	<u>300,963</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	

Notes on the Accounts (continued)

38 Interest rate analysis of financial instruments (continued)

Bank

2005	Up to 3 months		6 months		3 to 6 months		12 months		6 to 12 months		1 to 5 years		Over 5 years		Non-interest bearing		Total non-trading		Designated at fair value		Trading		Total		Effective interest rate	
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m		
Financial assets																										
Treasury bills	53,180	19,810	27,032	571	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	3.06%	
Loans and advances to banks	280,378	16,229	19,912	157	1,615	1,615	333,847	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	2.90%	
Loans and advances to customers	565,932	40,891	19,370	20,415	16,463	16,463	664,645	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	5.03%	
Debt securities	105,043	19,378	25,634	45,526	11,745	11,745	207,326	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	3.42%	
Other assets	111,480	—	—	—	—	—	438,484	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	3.18%	
	1,116,013	96,308	91,948	66,669	29,823	29,823	1,744,895	344,134	327,004	344,134	344,134	1,744,895	8,755	173,169	1,926,819	173,169	1,926,819	173,169	1,926,819	173,169	1,926,819	173,169	1,926,819	1,926,819	3.87%	
Financial liabilities																										
Deposits by banks	55,207	2,015	4,233	—	—	—	75,674	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	3.35%	
Customer accounts	1,068,645	28,378	18,986	8,841	837	837	1,247,079	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1,600	1.68%	
Debt securities in issue	12,839	4,873	2,507	1,048	—	—	21,267	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	4.56%	
Other liabilities	36,287	—	—	3	—	—	266,254	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	1.88%	
Subordinated liabilities	9,359	—	—	344	—	—	9,703	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	4.81%	
Preference shares	20,160	16,853	34,967	—	—	—	71,980	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	4.75%	
	1,202,497	52,119	60,693	10,236	837	837	1,691,957	365,575	365,575	365,575	365,575	1,691,957	1,959	175,127	1,869,043	175,127	1,869,043	175,127	1,869,043	175,127	1,869,043	175,127	1,869,043	1,869,043	1.99%	
Off-balance sheet	114,565	30,504	29,031	—	—	—	174,100	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	
Interest rate sensitivity gap	28,081	74,693	60,286	56,433	28,986	28,986	227,038	(21,441)	(21,441)	(21,441)	(21,441)	227,038	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)	(21,441)

38 Interest rate analysis of financial instruments (continued)

Group

2004	Up to 3 months		6 to 12 months		1 to 5 years		Over 5 years		Non-interest bearing		Total non-trading		Designated fair value at		Trading		Total		Effective interest rate	
	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$		
Financial assets																				
Treasury bills	66,645	23,897	27,436	1,865	—	—	—	—	—	—	119,843	—	—	—	—	—	—	119,843	1.59%	
Loans and advances to banks	402,962	12,371	3,446	173	5	—	—	—	10,214	429,171	—	—	—	—	—	—	429,171	2.07%		
Loans and advances to customers	780,102	65,437	21,626	27,378	21,133	—	—	—	3,516	919,192	—	—	—	—	—	—	919,192	3.75%		
Debt securities	228,526	45,972	58,364	140,110	29,904	—	—	—	—	502,876	—	—	—	—	82,159	—	585,035	2.85%		
Other assets	74,333	—	—	—	—	—	—	—	353,668	428,001	—	—	—	—	5,573	—	433,574	1.60%		
	<u>1,552,568</u>	<u>147,677</u>	<u>110,872</u>	<u>169,526</u>	<u>51,042</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>367,398</u>	<u>2,399,083</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>87,732</u>	<u>—</u>	<u>2,486,815</u>	<u>3.02%</u>		
Financial liabilities																				
Deposits by banks	57,478	791	2,597	—	—	—	—	—	14,114	74,980	—	—	—	—	—	—	74,980	1.97%		
Customer accounts	1,496,604	39,633	21,669	18,302	1,958	—	—	—	178,461	1,756,627	—	—	—	—	—	—	1,756,627	0.84%		
Debt securities in issue	58,058	12,029	10,731	68,037	6,307	—	—	—	—	155,162	—	—	—	—	—	—	155,162	3.77%		
Other liabilities	12,420	—	—	—	—	—	—	—	283,484	295,904	—	—	—	—	37,281	—	333,185	1.47%		
Subordinated liabilities	10,178	—	—	964	—	—	—	—	—	11,142	—	—	—	—	—	—	11,142	4.38%		
Preference shares	18,656	11,077	25,869	—	—	—	—	—	—	55,602	—	—	—	—	—	—	55,602	3.22%		
	<u>1,653,394</u>	<u>63,530</u>	<u>60,866</u>	<u>87,303</u>	<u>8,265</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>476,059</u>	<u>2,349,417</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>37,281</u>	<u>—</u>	<u>2,386,698</u>	<u>1.17%</u>		
Off-balance sheet	347,254	315,312	567,059	237,356	8,201	—	—	—	—	1,475,182	—	—	—	—	—	—	1,475,182	—	—	
Interest rate sensitivity gap	<u>246,428</u>	<u>399,459</u>	<u>617,065</u>	<u>319,579</u>	<u>50,978</u>	<u>(108,661)</u>	<u>1,524,848</u>	<u>—</u>	<u>(108,661)</u>	<u>1,524,848</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	

Notes on the Accounts (continued)

38 Interest rate analysis of financial instruments (continued)

Bank

2004	Up to 3 months		6 months		3 to 6 months		12 months		6 to 12 months		1 to 5 years		Over 5 years		Non-interest bearing		Total non-trading		Designated fair value		Trading		Total		Effective interest rate			
	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$	HK\$					
Financial assets																												
Treasury bills	63,991	22,431	23,930	1,865	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	112,217	1.61%		
Loans and advances to banks	326,993	9,249	1,526	173	5	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	346,447	1.94%		
Loans and advances to customers	498,027	47,368	14,745	20,252	15,813	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	597,674	3.85%		
Debt securities	128,748	35,684	39,450	70,392	8,685	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	362,113	3.51%		
Other assets	92,176	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	396,989	1.75%		
	<u>1,109,935</u>	<u>114,732</u>	<u>79,651</u>	<u>92,682</u>	<u>24,503</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>1,815,440</u>	<u>3.08%</u>		
Financial liabilities																												
Deposits by banks	49,111	791	2,597	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	66,197	1.83%	
Customer accounts	1,042,823	30,924	17,508	15,041	1,958	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	1,228,680	0.76%	
Debt securities in issue	27,169	7,831	7,723	58,930	6,760	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	108,413	3.98%	
Other liabilities	24,529	—	—	5	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	294,701	1.28%	
Subordinated liabilities	9,328	—	—	358	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	9,686	4.12%	
Preference shares	18,656	11,077	25,869	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	55,602	3.22%	
	<u>1,171,616</u>	<u>50,623</u>	<u>53,697</u>	<u>74,334</u>	<u>8,718</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>1,763,279</u>	<u>1.21%</u>	
Off-balance sheet	353,970	314,669	567,059	237,356	8,201	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	1,481,255	—
Interest rate sensitivity gap	<u>292,289</u>	<u>378,778</u>	<u>593,013</u>	<u>255,704</u>	<u>23,986</u>	<u>(62,638)</u>	<u>1,481,132</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>

39 Reconciliation of operating profit to cash generated from operations

	2005 HK\$m	2004 HK\$m Restated
Operating profit	43,344	43,237
Net interest income	(43,491)	(36,970)
Dividend income	(368)	(163)
Depreciation and amortisation	1,983	1,853
Impairment and other credit risk provisions	2,064	(862)
Advances written off net of recoveries	(3,268)	(4,066)
Other provisions for liabilities and charges	373	453
Provisions utilised	(99)	(672)
Surplus arising on property revaluation	(1,537)	(1,038)
Profit on disposal of property, plant and equipment	(104)	(192)
Profit on disposal of subsidiaries and associates	(53)	(342)
Gains less losses from financial investments	(756)	(1,497)
Employees' options granted cost free	333	242
Interest received	63,331	45,635
Interest paid	(31,956)	(18,052)
Operating profit before changes in working capital	29,796	27,566
Change in treasury bills with original term to maturity of more than three months	10,704	(49,096)
Change in placings with banks maturing after one month	4,139	38,639
Change in certificates of deposit with original term to maturity of more than three months	(2,351)	(5,422)
Change in trading assets	(85,741)	13,061
Change in trading liabilities	87,174	8,279
Change in financial assets designated at fair value	(1,001)	–
Change in financial liabilities designated at fair value	673	–
Change in derivative assets	15,122	(14,344)
Change in derivative liabilities	(21,007)	20,630
Change in financial investments held for backing liabilities to long-term policyholders	(8,227)	(12,137)
Change in advances to customers	(82,836)	(99,508)
Change in amounts due from fellow subsidiary companies	(20,058)	(25,203)
Change in other assets	13,558	(16,711)
Change in deposits by banks	11,147	4,289
Change in customer accounts	41,993	168,856
Change in amounts due to fellow subsidiary companies	6,438	6,006
Change in amounts due to ultimate holding company	1,949	178
Change in debt securities in issue	(2,221)	40,206
Change in liabilities to customers under insurance and investment contracts	17,271	13,445
Change in other liabilities	15,750	898
Exchange adjustments	(1,263)	925
Cash generated from operations	31,009	120,557

Notes on the Accounts (continued)**40 Analysis of cash and cash equivalents****a** *Change in cash and cash equivalents during the year*

	2005	2004
	HK\$m	HK\$m
Balance at 1 January	403,545	314,861
Net cash inflow before the effect of exchange movements	56,138	81,548
Effect of exchange movements	(15,169)	7,136
Balance at 31 December	444,514	403,545

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

	2005	2004
	HK\$m	HK\$m
Cash in hand and current balances with banks	86,882	54,509
Items in the course of collection from other banks	17,782	13,479
Placings with banks	310,396	336,292
Treasury bills	45,484	17,916
Certificates of deposit	4,897	4,801
Less: items in the course of transmission to other banks	(20,927)	(23,452)
	444,514	403,545

The difference between the amounts above and the amounts included in the consolidated balance sheet reflects treasury bills and certificates of deposit with an initial maturity of more than 3 months.

c *Analysis of net outflow of cash and cash equivalents in respect of acquisition of and increased shareholding in subsidiary companies*

	2005	2004
	HK\$m	HK\$m
Cash consideration	(2,391)	(972)
Cash and cash equivalents acquired	747	–
	(1,644)	(972)

d *Analysis of net inflow of cash and cash equivalents in respect of sale of subsidiary companies*

	2005	2004
	HK\$m	HK\$m
Sales proceeds	151	63
Cash and cash equivalents transferred	–	(24)
	151	39

41 Contingent liabilities and commitments

Group

	2005			2004		
	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Contingent liabilities:						
Acceptances and endorsements	–	–	–	22,714	4,559	4,423
Guarantees	83,114	60,166	48,893	87,243	65,884	48,837
Other contingent liabilities	37	37	37	35	35	33
	83,151	60,203	48,930	109,992	70,478	53,293
Commitments:						
Documentary credits and short-term trade-related transactions	55,402	20,650	10,905	48,493	13,770	9,591
Forward asset purchases and forward deposits placed	1,849	1,849	775	10,166	10,166	3,716
Undrawn note issuing and revolving underwriting facilities	3,249	1,625	975	4,116	2,058	1,680
Undrawn formal standby facilities, credit lines and other commitments:						
– one year and over	97,207	48,604	41,115	82,142	41,071	38,311
– under one year	752,797	–	–	657,682	–	–
	910,504	72,728	53,770	802,599	67,065	53,298

Notes on the Accounts (continued)**41 Contingent liabilities and commitments** (continued)*Bank*

	2005			2004		
	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Contingent liabilities:						
Acceptances and endorsements	–	–	–	19,788	3,974	3,839
Guarantees	85,796	64,041	42,583	87,456	67,223	43,083
Other contingent liabilities	32	32	32	34	34	33
	85,828	64,073	42,615	107,278	71,231	46,955
Commitments:						
Documentary credits and short-term trade-related transactions	49,414	19,147	9,714	41,056	11,880	8,099
Forward asset purchases and forward deposits placed	1,347	1,347	417	8,280	8,280	1,830
Undrawn note issuing and revolving underwriting facilities	3,249	1,625	975	4,116	2,058	1,680
Undrawn formal standby facilities, credit lines and other commitments:						
– one year and over	68,341	34,171	26,557	51,001	25,500	22,908
– under one year	615,856	–	–	546,364	–	–
	738,207	56,290	37,663	650,817	47,718	34,517

The tables above give the nominal contract amounts, credit equivalent amounts and risk-weighted amounts of contingent liabilities and commitments. The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Third Schedule of the Hong Kong Banking Ordinance (the 'Third Schedule') on capital adequacy and depend on the status of the counterparty and the maturity characteristics. The risk weights used range from 0% to 100%.

In accordance with the Third Schedule, contingent liabilities and commitments are credit-related instruments which include acceptances and endorsements, letters of credit, guarantees and commitments to extend credit. The contract amounts represent the amounts at risk should the contract be fully drawn upon and the client default. Since a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

For the purpose of these financial statements, acceptances and endorsements are recognised on the balance sheet at 31 December 2005 in 'Other assets' and 'Other liabilities' in accordance with HKAS 39. For the purpose of the Third Schedule, these acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies.

No netting agreements have been taken into account when arriving at the above amounts.

42 Assets pledged as security for liabilities

Liabilities of the group amounting to HK\$42,887 million (2004: HK\$31,963 million) and of the Bank amounting to HK\$22,664 million (2004: HK\$26,260 million) are secured by the deposit of assets, including assets subject to sale and repurchase agreements. The amount of assets pledged by the group to secure these liabilities is HK\$44,112 million (2004: HK\$35,257 million) and by the Bank is HK\$23,799 million (2004: HK\$29,515 million). These assets comprise treasury bills and debt securities. In addition, the amount of debt securities deposited with clearing houses by the group to facilitate settlement processes is HK\$135,942 million (2004: HK\$188,459 million) and by the Bank is HK\$128,589 million (2004: HK\$180,480 million).

43 Capital commitments

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Expenditure contracted for	1,979	2,258	303	307
Expenditure authorised by the Directors but not contracted for	67	89	60	72
	2,046	2,347	363	379

The capital commitments mainly relate to the commitment to purchase premises and equipment as well as to increase the investment in the HSBC Private Equity Fund 3 Limited which has committed to make private equity investments in Asian companies that are seeking capital to expand existing operations or fund management buy-outs.

44 Lease commitments

The group leases certain properties and equipment under operating leases. The leases normally run for a period of one to ten years and may include an option to renew. Lease payments are usually adjusted annually to reflect market rentals. None of the leases includes contingent rentals. Future minimum lease payments under non-cancellable operating leases are as follows:

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Premises				
Amounts payable within				
– one year or less	1,224	900	884	588
– five years or less but over one year	1,845	843	1,086	620
– over five years	193	63	180	53
	3,262	1,806	2,150	1,261
Equipment				
Amounts payable within				
– one year or less	52	43	37	33
– five years or less but over one year	166	102	123	63
	218	145	160	96

Notes on the Accounts (continued)**45 Segmental analysis**

Segmental information is presented in respect of the group's geographical and business segments. Geographical segment information is chosen as the primary reporting format as this aligns more closely with the group's internal financial reporting.

a *By geographical region*

The allocation of earnings reflects the benefits of shareholders' funds to the extent that these are actually allocated to businesses in the segment by way of intra-group capital and funding structures.

Interest is charged based on market rates. Common costs are included in segments on the basis of the actual recharges made. Geographical information has been classified by the location of the principal operations of the subsidiary company or, in the case of the Bank, by the location of the branch responsible for reporting the results or advancing the funds. Due to the nature of the group structure, the analysis of profits and net assets shown below includes intra-group items between geographical regions.

Segment assets:

	2005		2004	
	HK\$m	%	HK\$m	%
			Restated	Restated
Hong Kong	1,870,122	70.0	1,829,378	73.6
Rest of Asia-Pacific	796,383	29.8	649,306	26.1
Americas/Europe	6,027	0.2	8,131	0.3
	2,672,532	100.0	2,486,815	100.0

Net assets:

	2005		2004	
	HK\$m	%	HK\$m	%
			Restated	Restated
Hong Kong	66,050	67.9	64,017	76.4
Rest of Asia-Pacific	31,091	31.9	19,593	23.4
Americas/Europe	193	0.2	197	0.2
	97,334	100.0	83,807	100.0

Capital additions during the year:

	2005		2004	
	HK\$m	%	HK\$m	%
			Restated	Restated
Hong Kong	1,884	78.6	1,605	24.8
Rest of Asia-Pacific	514	21.4	4,867	75.2
	2,398	100.0	6,472	100.0

45 Segmental analysis (continued)

Investment in associates:

	2005		2004	
	HK\$m	%	HK\$m	%
Hong Kong	840	3.6	733	4.5
Rest of Asia-Pacific	22,221	96.4	15,610	95.5
	23,061	100.0	16,343	100.0

Segment liabilities:

	2005		2004	
	HK\$m	%	HK\$m	%
Hong Kong	1,804,072	70.1	1,765,361	73.5
Rest of Asia-Pacific	765,292	29.7	629,713	26.2
Americas/Europe	5,834	0.2	7,934	0.3
	2,575,198	100.0	2,403,008	100.0

Minority interests are included in the above table.

Credit commitments (contract amounts):

	2005		2004	
	HK\$m	%	HK\$m	%
Hong Kong	601,438	60.5	572,865	62.8
Rest of Asia-Pacific	392,217	39.5	339,726	37.2
	993,655	100.0	912,591	100.0

Notes on the Accounts (continued)**45 Segmental analysis** (continued)

Consolidated income statement:

	<u>Hong Kong</u> HK\$m	<u>Rest of Asia-Pacific</u> HK\$m	<u>Americas/ Europe</u> HK\$m	<u>Total</u> HK\$m
2005				
Interest income from third parties and fellow subsidiaries	51,641	28,323	235	80,199
Inter-segment interest income	<u>3,498</u>	<u>1,290</u>	<u>294</u>	<u>5,082</u>
Interest income	55,139	29,613	529	85,281
Interest expense to third parties and fellow subsidiaries	(22,421)	(14,088)	(199)	(36,708)
Inter-segment interest expense	<u>(1,728)</u>	<u>(3,248)</u>	<u>(106)</u>	<u>(5,082)</u>
Interest expense	(24,149)	(17,336)	(305)	(41,790)
Net interest income	30,990	12,277	224	43,491
Fee income	14,237	7,921	2	22,160
Fee expense	(2,252)	(1,803)	(8)	(4,063)
Net trading income	3,152	4,198	(170)	7,180
Net income from financial instruments designated as at fair value	(69)	453	–	384
Gains less losses from financial investments	714	42	–	756
Dividend income	350	18	–	368
Net earned insurance premiums	18,140	1,200	–	19,340
Other operating income	<u>6,480</u>	<u>1,131</u>	<u>22</u>	<u>7,633</u>
Total operating income	71,742	25,437	70	97,249
Net insurance claims incurred and movement in policyholder liabilities	<u>(16,002)</u>	<u>(1,289)</u>	<u>–</u>	<u>(17,291)</u>
Net operating income before loan impairment charges and other credit risk provisions	55,740	24,148	70	79,958
Loan impairment charges and other credit risk provisions	<u>(1,161)</u>	<u>(915)</u>	<u>12</u>	<u>(2,064)</u>
Net operating income	54,579	23,233	82	77,894
Operating expenses	<u>(20,514)</u>	<u>(13,998)</u>	<u>(38)</u>	<u>(34,550)</u>
Operating profit	34,065	9,235	44	43,344
Share of profit in associates	<u>178</u>	<u>1,727</u>	<u>–</u>	<u>1,905</u>
Profit before tax	34,243	10,962	44	45,249
Tax expense	<u>(5,411)</u>	<u>(2,634)</u>	<u>(6)</u>	<u>(8,051)</u>
Profit for the year	<u>28,832</u>	<u>8,328</u>	<u>38</u>	<u>37,198</u>
Attributable to shareholders	24,644	8,191	38	32,873
Attributable to minority interests	4,188	137	–	4,325
Net operating income before loan impairment				
– external	53,215	24,570	(186)	77,599
– inter-company/inter-segment	2,525	(422)	256	2,359
Depreciation and amortisation included in operating expenses	(1,487)	(495)	(1)	(1,983)

45 Segmental analysis (continued)

	<u>Hong Kong</u>	<u>Rest of Asia-Pacific</u>	<u>Americas/ Europe</u>	<u>Total</u>
	HK\$m	HK\$m	HK\$m	HK\$m
2004 (restated)				
Interest income from third parties and fellow subsidiaries	36,605	21,179	163	57,947
Inter-segment interest income	<u>1,928</u>	<u>598</u>	<u>438</u>	<u>2,964</u>
Interest income	38,533	21,777	601	60,911
Interest expense to third parties and fellow subsidiaries	(11,035)	(9,644)	(298)	(20,977)
Inter-segment interest expense	<u>(1,176)</u>	<u>(1,611)</u>	<u>(177)</u>	<u>(2,964)</u>
Interest expense	(12,211)	(11,255)	(475)	(23,941)
Net interest income	26,322	10,522	126	36,970
Fee income	13,717	6,066	1	19,784
Fee expense	(1,913)	(1,578)	(12)	(3,503)
Net trading income	4,413	2,590	–	7,003
Net investment income on assets backing policyholder liabilities	669	229	–	898
Gains less losses from financial investments	1,361	135	1	1,497
Dividend income	148	15	–	163
Net earned insurance premiums	13,351	734	–	14,085
Other operating income	<u>4,686</u>	<u>726</u>	<u>8</u>	<u>5,420</u>
Total operating income	62,754	19,439	124	82,317
Net insurance claims incurred and movement in policyholder liabilities	<u>(11,098)</u>	<u>(627)</u>	<u>–</u>	<u>(11,725)</u>
Net operating income before loan impairment charges and other credit risk provisions	51,656	18,812	124	70,592
Loan impairment charges and other credit risk provisions	<u>1,684</u>	<u>(828)</u>	<u>6</u>	<u>862</u>
Net operating income	53,340	17,984	130	71,454
Operating expenses	<u>(17,917)</u>	<u>(10,268)</u>	<u>(32)</u>	<u>(28,217)</u>
Operating profit	35,423	7,716	98	43,237
Share of profit in associates	<u>52</u>	<u>247</u>	<u>–</u>	<u>299</u>
Profit before tax	35,475	7,963	98	43,536
Tax expense	<u>(4,768)</u>	<u>(2,214)</u>	<u>(6)</u>	<u>(6,988)</u>
Profit for the year	<u>30,707</u>	<u>5,749</u>	<u>92</u>	<u>36,548</u>
Attributable to shareholders	26,334	5,722	92	32,148
Attributable to minority interests	4,373	27	–	4,400
Net operating income before loan impairment				
– external	50,725	18,692	(164)	69,253
– inter-company/inter-segment	931	120	288	1,339
Depreciation and amortisation included in operating expenses	(1,389)	(463)	(1)	(1,853)

Interest income and interest expense include intra-group interest of HK\$5,082 million (2004: HK\$2,964 million). Fee income and fee expense include intra-group fees of HK\$489 million (2004: HK\$308 million). Other operating income and operating expenses include intra-group items of HK\$2,736 million (2004: HK\$1,306 million).

Notes on the Accounts (continued)**45 Segmental analysis** (continued)**b** *By customer group*

The group comprises five major customer groups. Personal Financial Services provides financial services to individuals, including self employed individuals (but excluding individuals managed by Private Banking). Commercial Banking manages middle and smaller corporate relationships. Corporate, Investment Banking and Markets includes the relationships with large corporate and institutional customers together with the group's treasury and investment banking operations. Private Banking provides financial services to high net worth individuals, who have complex financial affairs. Other mainly represents investments in premises, investment properties and shareholders' funds to the extent that they have not been allocated to the other business segments as well as adjustments to eliminate intra-group items between business segments.

Operating expenses are allocated to individual segments where:

- (a) they are clearly attributable to that segment (for example, rent, staff costs for employees of that segment, etc); and
- (b) where they are allocations of certain central costs and support services, which are made on a basis which is designed broadly to reflect the utilisation of such resources by each segment.

	<i>Personal Financial Services</i>	<i>Commercial Banking</i>	<i>Corporate, Investment Banking and Markets</i>	<i>Private Banking</i>	<i>Other</i>	<i>Total</i>
	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>	<u>HK\$m</u>
2005						
Net interest income	26,801	11,089	8,725	63	(3,187)	43,491
Net fee income	8,050	4,524	5,388	55	80	18,097
Net trading income	683	638	7,215	10	(1,366)	7,180
Net income from financial instruments designated as at fair value	666	(648)	122	–	244	384
Gains less losses from financial investments	–	23	19	–	714	756
Dividend income	5	14	167	–	182	368
Net earned insurance premiums	18,437	756	147	–	–	19,340
Other operating income	1,984	295	572	13	2,033	4,897
Total operating income	<u>56,626</u>	<u>16,691</u>	<u>22,355</u>	<u>141</u>	<u>(1,300)</u>	<u>94,513</u>
Net insurance claims incurred and movement in policyholder liabilities	<u>(16,889)</u>	<u>(330)</u>	<u>(72)</u>	<u>–</u>	<u>–</u>	<u>(17,291)</u>
Net operating income before loan impairment charges and other credit risk provisions	39,737	16,361	22,283	141	(1,300)	77,222
Loan impairment charges and other credit risk provisions	<u>(1,344)</u>	<u>(896)</u>	<u>165</u>	<u>–</u>	<u>11</u>	<u>(2,064)</u>
Net operating income	38,393	15,465	22,448	141	(1,289)	75,158
Operating expenses	<u>(16,932)</u>	<u>(5,424)</u>	<u>(9,642)</u>	<u>(113)</u>	<u>297</u>	<u>(31,814)</u>
Operating profit	21,461	10,041	12,806	28	(992)	43,344
Share of profit in associates	<u>179</u>	<u>1,090</u>	<u>446</u>	<u>–</u>	<u>190</u>	<u>1,905</u>
Profit before tax	<u>21,640</u>	<u>11,131</u>	<u>13,252</u>	<u>28</u>	<u>(802)</u>	<u>45,249</u>

45 Segmental analysis (continued)

	<i>Personal Financial Services</i>	<i>Commercial Banking</i>	<i>Corporate, Investment Banking and Markets</i>	<i>Private Banking</i>	<i>Other</i>	<i>Total</i>
2005	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Net operating income before loan impairment						
– external	19,981	12,543	40,749	95	4,231	77,599
– inter-company/ inter-segment	19,756	3,818	(18,466)	46	(5,531)	(377)
Segment assets	602,268	289,360	1,756,091	3,262	(1,510)	2,649,471
Interest in associates	2,048	13,418	5,406	–	2,189	23,061
Total assets	604,316	302,778	1,761,497	3,262	679	2,672,532
Net assets	20,305	18,464	30,336	85	28,144	97,334
Capital additions during the year	318	73	32	–	1,975	2,398
	<i>Personal Financial Services</i>	<i>Commercial Banking</i>	<i>Corporate, Investment Banking and Markets</i>	<i>Private Banking</i>	<i>Other</i>	<i>Total</i>
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
2004 (restated)						
Net interest income	20,785	7,065	11,258	35	(2,173)	36,970
Net fee income	7,524	4,111	5,012	42	(408)	16,281
Net trading income	617	520	5,795	5	66	7,003
Net investment income on assets backing policyholder liabilities	1,088	81	–	–	(271)	898
Gains less losses from financial investments	(13)	1	64	–	1,445	1,497
Dividend income	18	6	17	–	122	163
Net earned insurance premiums	13,186	751	148	–	–	14,085
Other operating income	2,439	449	883	1	342	4,114
Total operating income	45,644	12,984	23,177	83	(877)	81,011
Net insurance claims incurred and movement in policyholder liabilities	(11,441)	(191)	(93)	–	–	(11,725)
Net operating income before loan impairment charges and other credit risk provisions	34,203	12,793	23,084	83	(877)	69,286
Loan impairment charges and other credit risk provisions	(1,290)	638	1,519	–	(5)	862
Net operating income	32,913	13,431	24,603	83	(882)	70,148
Operating expenses	(15,659)	(4,784)	(7,288)	(74)	894	(26,911)
Operating profit	17,254	8,647	17,315	9	12	43,237
Share of profit in associates	73	170	20	–	36	299
Profit before tax	17,327	8,817	17,335	9	48	43,536

Notes on the Accounts (continued)**45 Segmental analysis** (continued)

	<i>Personal Financial Services</i>	<i>Commercial Banking</i>	<i>Corporate, Investment Banking and Markets</i>	<i>Private Banking</i>	<i>Other</i>	<i>Total</i>
2004 (restated)	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Net operating income before loan impairment						
– external	24,027	10,620	29,988	74	4,544	69,253
– inter-company/inter-segment	10,176	2,173	(6,904)	9	(5,421)	33
Segment assets	546,999	264,500	1,677,063	2,868	(20,958)	2,470,472
Interest in associates	3,581	11,442	492	–	828	16,343
Total assets	550,580	275,942	1,677,555	2,868	(20,130)	2,486,815
Net assets	19,324	11,758	26,279	63	26,383	83,807
Capital additions during the year	1,330	3,324	729	–	1,089	6,472

Other operating income and operating expenses in ‘Other’ include an adjustment of HK\$4,305 million to eliminate intra-group items (2004 restated: HK\$4,953 million).

46 Related-party transactions**a Holding company**

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

Transactions with the immediate parent company included the issuance of preference shares and the payment of interest on preference shares. As at 31 December 2005, the Bank has issued HK\$48,873 million of preference shares to its immediate holding company and HK\$23,107 million to a fellow subsidiary company. These are classified as liabilities on the balance sheet.

Income and expenses for the year

	<i>Immediate holding company</i>		<i>Ultimate holding company</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Interest expense	2,344	1,467	12	80
Other operating income	–	–	10	14
Other operating expenses	–	–	674	563

Information relating to preference shares can be found in the ‘Notes on the Financial Statements’ where the following are disclosed:

- Note 4b: interest expense on preference shares;
- Note 34: preference shares issued.

Balances at 31 December

Balances with the ultimate holding company are disclosed on the face of the consolidated balance sheet and the balance sheet of the Bank.

46 Related-party transactions (continued)

Share option schemes

The group participates in various share option plans operated by HSBC Holdings plc whereby share options of HSBC Holdings plc are granted to employees of the group. As disclosed in Note 49, the group recognises an expense in respect of these share options. The cost borne by the ultimate holding company in respect of these share options is treated as a capital contribution and is recorded under 'Other reserves'. The balance of this reserve as at 31 December 2005 amounted to HK\$629 million (2004: HK\$322 million).

b Fellow subsidiaries

In 2005, the group entered into transactions with its fellow subsidiary companies in the normal course of business including the acceptance and placement of interbank deposits, correspondent banking transactions and off-balance sheet transactions. The activities were priced at the relevant market rates at the time of the transactions.

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

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

Income and expenses for the year

	<u>2005</u>	<u>2004</u>
	HK\$m	HK\$m
Interest income	1,688	736
Interest expense ¹	920	141
Fee income	718	597
Fee expense	448	378
Other operating income	839	687
Other operating expenses ²	1,225	901

1 2005 included interest on preference shares of HK\$666m. In 2004, all the preference shares were held by the immediate holding company and the ultimate holding company.

2 2005 included payment of HK\$472m of software costs which were capitalised as intangible assets in the balance sheet of the Bank.

Balances at 31 December

Balances due from and to fellow subsidiary companies are disclosed on the face of the consolidated balance sheet and the balance sheet of the Bank. Balances due to and from subsidiaries companies are disclosed on the face of the balance sheet of the Bank.

c Associates

Information relating to associated companies can be found in Note 19 where the following are disclosed:

- investments in associates;
- amounts due from and to associates;
- principal associates.

Material transactions with associates relate to the provision of services in the Initial Public Offering for the Bank of Communications Limited (BoCom), whereby fee income generated amounted to HK\$231 million in 2005. The Bank has entered into Technical Support and Assistance Agreement with BoCom to provide technical support and assistance in relation to the banking business of BoCom. The Bank has assisted BoCom in forming a credit card division and provided technical support in the issuing of co-branded credit cards with HSBC.

Notes on the Accounts (continued)**46 Related-party transactions** (continued)**d Key management personnel***Key management compensation*

	<u>2005</u>	<u>2004</u>
	HK\$m	HK\$m
Salaries and other short-term benefits	138	104
Post-employment benefits	9	9
Share-based payments	<u>39</u>	<u>26</u>
	<u>186</u>	<u>139</u>

Sir John Bond and S K Green are, respectively, the Group Chairman and the Group Chief Executive of HSBC Holdings plc. Their remuneration for services rendered to the HSBC Group, as a whole, is included in the financial statements of HSBC Holdings plc. No separate charge is made to the Bank or the group in this respect.

Directors emoluments

Information on directors' emoluments is disclosed in Note 4n.

Loans to officers

Particulars of loans to officers disclosed pursuant to section 161B of the Hong Kong Companies Ordinance:

	<i>Aggregate amount of relevant loans outstanding at 31 December</i>		<i>Maximum aggregate amount of relevant loans outstanding during the year</i>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
	HK\$m	HK\$m	HK\$m	HK\$m
By the Bank	187	172	216	303
By subsidiary companies	–	106	10	129
	<u>187</u>	<u>278</u>	<u>226</u>	<u>432</u>

e Pension funds

At 31 December 2005, HK\$11.7 billion (2004: HK\$11.1 billion) of pension fund assets were under management by a wholly-owned subsidiary.

f Other related parties

In the normal course of business, the Bank and the group enter into banking transactions with companies that may be directly or indirectly influenced or controlled by certain directors or their close family members. The aggregate average assets resulting from these transactions in 2005 were HK\$23,474 million (2004: HK\$34,038 million) and the average liabilities were HK\$12,569 million (2004: HK\$12,499 million). The aggregate contribution to the group's profit before tax from such transactions in 2005 was HK\$536 million (2004: HK\$509 million).

47 Capital adequacy ratios

The group's capital adequacy ratios adjusted for market risks calculated in accordance with the Hong Kong Monetary Authority Guideline on 'Maintenance of Adequate Capital Against Market Risks' are as follows:

	2005	2004
Total capital	<u>12.4%</u>	<u>11.9%</u>
Tier 1 capital	<u>11.7%</u>	<u>11.4%</u>

The group's capital adequacy ratios calculated in accordance with the provisions of the Third Schedule of the Banking Ordinance, which does not take into account market risks are as follows:

Total capital	<u>12.0%</u>	<u>11.9%</u>
Tier 1 capital	<u>11.2%</u>	<u>11.4%</u>

48 Liquidity ratio

The Hong Kong Banking Ordinance requires banks operating in Hong Kong to maintain a minimum liquidity ratio, calculated in accordance with the provisions of the Fourth Schedule of the Hong Kong Banking Ordinance, of 25%. This requirement applies separately to the Hong Kong branches of the Bank and to those subsidiary companies which are Authorised Institutions under the Banking Ordinance in Hong Kong.

The average liquidity ratio for the year was as follows:

	2005	2004
Hong Kong branches of the Bank	<u>48.2%</u>	<u>41.7%</u>

49 Share-based payments

HSBC operates both share option schemes and share award schemes. These are to be settled by the delivery of shares of HSBC Holdings plc.

Calculation of fair value

The fair value of services received in return for share options/shares granted is measured by reference to the fair value of share options/shares granted.

Fair value of share options/shares awarded in 2005, measured at the date of grant of the option/award, is calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options/awards with vesting dependent on HSBC's Total Shareholder Return over a period, these performance targets are incorporated into the model using Monte-Carlo simulation. Non-market conditions, such as HSBC meeting earnings per share targets, are not incorporated into the calculation of fair value at grant date but are reflected in the amount of compensation expense accrued over the vesting period.

The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair value calculated is inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted in 2005 are as follows:

	<i>Group Share Option Plan</i>	<i>3 year Savings- Related Share Option Schemes</i>	<i>5 year Savings- Related Share Option Schemes</i>
Risk-free interest rate (%)	<u>4.6</u>	<u>4.3</u>	<u>4.3</u>
Expected life (years)	<u>7.8</u>	<u>3.0</u>	<u>5.0</u>
Expected volatility (%)	<u>20</u>	<u>20</u>	<u>20</u>

Notes on the Accounts (continued)

49 Share-based payments (continued)

The risk-free rate was determined from the UK gilts yield curve for Group Share Option Plan awards and Savings-Related Share Option Schemes. Expected life is not a single input parameter but a function of various behavioural assumptions. Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options. Expected dividend yield was based on historic levels of dividend growth.

Share Option Schemes

The share option schemes include The HSBC Holdings Group Share Option Plan, Executive Share Option Scheme and Savings-Related Share Option Plans. In order to align the interests of staff with those of shareholders, share options are awarded to employees under all employee shares plans and discretionary share incentive plans.

a *Executive Share Option Scheme and Group Share Option Plan*

The Executive Share Option Scheme and Group Share Option Plan are long-term incentive schemes available to certain HSBC employees with grants usually made each year. The aim of the plan is to align the interests of those employees assessed as higher-performing to the creation of the shareholder value. This is achieved by setting certain Total Shareholder Return targets which must normally be attained in order for the awards to vest.

The Executive Share Option Scheme ('ESOS') ran from October 1993 until April 2000, after which it was replaced by the Group Share Option ('GSOP') due to a change in UK legislation. In broad terms, the ESOS and GSOP are similar, in that:

- options are granted as part of the annual review process in recognition of past performance and future potential;
- the exercise price of the options is equal to the share price at the date of grant. The options are normally become exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions.

Exercise of ESOS options has to be done within 12 months following the date that employees' service with the HSBC Group ceases. After 12 months, the options will lapse.

For GSOP, options cannot be exercised until the performance conditions have been passed. The test of the performance conditions will be on, or around, the third anniversary of the option grant date. If the performance conditions have not been achieved by the third anniversary, there is a further re-test at the fourth anniversary and, if still not passed, one further test at the fifth anniversary. If the performance conditions have still not been achieved, the options will lapse.

49 Share-based payments (continued)

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, are as follows:

Group

	2005		2004	
	<i>Number</i>	<i>Weighted average exercise price</i>	<i>Number</i>	<i>Weighted average exercise price</i>
	(000)	£	(000)	£
Outstanding at 1 January	35,808	7.77	30,687	7.56
Granted in the year	–	–	8,747	8.25
Exercised in the year	(2,705)	7.55	(2,507)	6.80
Lapsed in the year	(1,195)	7.59	(1,119)	7.89
Outstanding at 31 December	<u>31,908</u>	<u>7.79</u>	<u>35,808</u>	<u>7.77</u>
Exercisable at 31 December	<u>16,677</u>		<u>13,043</u>	

Bank

	2005		2004	
	<i>Number</i>	<i>Weighted average exercise price</i>	<i>Number</i>	<i>Weighted average exercise price</i>
	(000)	£	(000)	£
Outstanding at 1 January	26,876	7.77	23,472	7.54
Granted in the year	–	–	6,528	8.25
Exercised in the year	(1,971)	7.57	(2,172)	6.76
Lapsed in the year	(748)	7.87	(952)	7.87
Outstanding at 31 December	<u>24,157</u>	<u>7.79</u>	<u>26,876</u>	<u>7.77</u>
Exercisable at 31 December	<u>12,755</u>		<u>9,889</u>	

The weighted average share price at the date of exercise for share options exercised during the period was GBP9.02.

The options outstanding at 31 December 2005 have a weighted average exercise price of GBP7.79, and a weighted average contractual life of 6.4 years.

No new awards were made under this plan in 2005.

Notes on the Accounts (continued)**49 Share-based payments** (continued)**b Savings-Related Share Option Schemes**

The Savings-Related Share Option Schemes invite eligible employees to enter into savings contracts to save up to GBP250 per month, with the option to use the savings to acquire shares. The options are exercisable within six months following either the third or the fifth anniversary of the commencement of the savings contract depending on conditions set at grant. There is generally one Sharesave grant each year (in April or May).

The employee has the right to withdraw their accumulated savings and withdraw from the plan at any time. Upon voluntary withdrawal, any remaining unamortised compensation expense is recognised in the current period.

The exercise price is at a 20% discount to the market price (option price set before the annual invitation date), and the options have a vesting period of 3 or 5 years.

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, are as follows:

Group

	2005		2004	
	<i>Number</i>	<i>Weighted average exercise price</i>	<i>Number</i>	<i>Weighted average exercise price</i>
	(000)	£	(000)	£
Outstanding at 1 January	31,297	5.93	37,665	5.76
Granted in the year	9,750	6.68	8,120	6.47
Forfeited/expired in the year	(1,632)	6.06	(2,032)	5.90
Exercised in the year	(11,055)	6.07	(12,456)	5.78
Outstanding at 31 December	<u>28,360</u>	<u>6.12</u>	<u>31,297</u>	<u>5.93</u>
Exercisable at 31 December	<u>82</u>		<u>150</u>	

Bank

	2005		2004	
	<i>Number</i>	<i>Weighted average exercise price</i>	<i>Number</i>	<i>Weighted average exercise price</i>
	(000)	£	(000)	£
Outstanding at 1 January	22,915	5.92	26,348	5.79
Granted in the year	7,662	6.68	4,669	6.47
Forfeited/expired in the year	(1,093)	6.09	(1,499)	5.92
Exercised in the year	(9,031)	6.07	(6,603)	5.83
Outstanding at 31 December	<u>20,453</u>	<u>6.12</u>	<u>22,915</u>	<u>5.92</u>
Exercisable at 31 December	<u>78</u>		<u>118</u>	

The weighted average share price at the date of exercise for share options exercised during the period was GBP9.29.

The options outstanding at 31 December 2005 had a weighted average exercise price of GBP6.12, and a weighted average contractual life of 2.48 years.

49 Share-based payments (continued)

HSBC Share Plan

The HSBC Share Plan was adopted by HSBC in 2005 and is similar to the Restricted Share Plan which operated from 1996 to 2004. This plan comprises Performance Share Awards, Restricted Share Awards and Achievement Share Awards. The aim of the share plan is to align the interests of executives to the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

a *Performance Share Awards*

Performance share awards are made to the group's most senior executives taking into account individual performance in the prior year. The share awards are divided into two equal parts for testing attainment against pre-determined benchmarking. One half is subject to a Total Shareholder Return ('TSR') measure and the other half of the award is subject to an Earnings Per Share ('EPS') target. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if HSBC performance fails to meet the minimum criteria. (Prior to 2005, performance shares were only subject to a corporate TSR performance condition). Additional awards will be made during the 3-year life of the award representing the equivalent value of dividends. At the end of 3 years, the original award together with the additional share awards will be released.

Group

	2005	2004
	<i>Number</i>	<i>Number</i>
	(000)	(000)
Outstanding at 1 January	2,801	2,268
Additions during the year	833	935
Released in the year	(559)	(402)
Lapsed in the year	(72)	–
Outstanding at 31 December	<u>3,003</u>	<u>2,801</u>

Bank

	2005	2004
	<i>Number</i>	<i>Number</i>
	(000)	(000)
Outstanding at 1 January	2,205	1,762
Additions during the year	691	758
Released in the year	(390)	(315)
Lapsed in the year	(33)	–
Outstanding at 31 December	<u>2,473</u>	<u>2,205</u>

The weighted average purchase price for the awards granted during the year was GBP8.58. The weighted average remaining vesting period was 2.22 years.

The fair value of shares granted during the year with TSR conditions as at the year end was GBP5.30 while shares with EPS conditions had a fair value of GBP9.33 as at year end.

Notes on the Accounts (continued)**49 Share-based payments** (continued)**b Restricted Share Awards**

Restricted share awards are made to eligible employees for recruitment and retention purposes or as part of deferral of annual bonus. The awards vest between one and three years from date of award.

Group

	2005	2004
	<i>Number</i>	<i>Number</i>
	(000)	(000)
Outstanding at 1 January	4,902	4,394
Additions during the year	3,380	2,055
Released in the year	(2,890)	(1,563)
Lapsed in the year	(44)	16
Outstanding at 31 December	<u>5,348</u>	<u>4,902</u>

Bank

	2005	2004
	<i>Number</i>	<i>Number</i>
	(000)	(000)
Outstanding at 1 January	4,668	4,055
Additions during the year	3,358	1,956
Released in the year	(2,800)	(1,359)
Lapsed in the year	(43)	16
Outstanding at 31 December	<u>5,183</u>	<u>4,668</u>

The weighted average purchase price for the awards granted during the year was GBP8.77. The weighted average remaining vesting period as at 31 December 2005 was 1.65 years.

The closing price of HSBC Holdings shares on 31 December 2005 was GBP9.33.

c Achievement Share Awards

Achievement shares were launched in 2005 and were utilised to promote widespread interest in HSBC shares amongst employees and are awarded to eligible employees after taking into account of the employee's performance in the prior year. High-performing and/or high-potential senior and middle managers are normally eligible to receive achievement shares as part of the annual pay review process. Shares are awarded without corporate performance conditions and are released to employees after three years provided the employees have remained employed by the group for this period.

Additional awards are made during the 3-year vesting period. At the end of three years, the original award together with the additional share awards will be released.

Group

	2005
	<i>Number</i>
	(000)
Granted in the year	674
Lapsed in the year	(13)
Outstanding at 31 December	<u>661</u>

49 Share-based payments (continued)

Bank

	2005
	<i>Number</i>
	(000)
Granted in the year	548
Lapsed in the year	(11)
Outstanding at 31 December	537

The weighted average purchase price for the shares granted during the year was GBP8.45. The weighted average remaining vesting period as at 31 December 2005 was 2.25 years.

Employee expenses

The following amounts were recognised during the year in respect of share-based payment transactions:

	2005	2004
	HK\$m	HK\$m
Share options granted	333	242
Expense arising from cash-settled share-based payment transactions	543	224
Total expense recognised as employee costs	876	466
Total carrying amount of cash-settled transaction liabilities	576	211

50 Risk Management

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

- credit risk,
- liquidity risk, and
- market risk (including foreign exchange, interest rate and equity price risks)

The HSBC Group Head Office formulates high-level risk management policies for the HSBC Group worldwide. The group's risk management policies and procedures are subject to a high degree of oversight and guidance to ensure that financial and other risks are systematically identified, measured, analysed and actively managed.

(i) 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, treasury and leasing activities. The group has dedicated standards, policies and procedures to control and monitor all such risks.

The group has a well established credit risk management process which involves the delegation of approval authorities, control of exposures including those to borrowers in financial difficulty, and monitoring of exposures.

Both the HSBC Group and the Bank Executive Committees receive regular reports on credit exposures. These include information on large credit exposures, concentrations, industry exposures, levels of impairment provisioning and country exposures.

The HSBC Group Head Office is responsible for formulating high-level credit policies; the independent review of larger credit exposures; the control of cross-border exposures, as well as those to banks and financial institutions; and the portfolio management of risk concentrations. It also reviews the efficiency of credit approval processes, a key element of which is the HSBC Group's credit facility grading system. This is kept under constant review and is regularly updated.

Notes on the Accounts (continued)

50 Risk Management (continued)

Within the group, the Chief Executive Officer and the Chief Credit Officer are responsible for the quality and performance of the group's credit portfolio and for monitoring and controlling all credit risks in the group's portfolios, including those which are subject to central approval by HSBC Group Head Office. This includes policies on collateral and customer vetting processes.

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 analysis of advances to customers shown in Note 15b is based on the categories used by the HSBC Group, including the Bank and its subsidiaries, to manage the associated risks. The analysis shows the maximum amounts which could be lost as a result of the failure of the counterparties before taking account of any security.

Details of contingent liabilities and commitments are included in Note 41.

(ii) Liquidity risk

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

Management of liquidity is carried out both at group and Bank level 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 appropriately balanced and all funding obligations are met when due.

It is the responsibility of local management to ensure compliance with local regulatory and Executive Committee requirements. Liquidity is managed on a daily basis by local treasury functions, with the larger treasury sites providing support to smaller entities where required.

Compliance with liquidity requirements is monitored by local Asset and Liability Management Committees which report to HSBC Group Head Office on a regular basis. This process includes:

- projecting cash flows by major currency and a consideration of the level of liquid assets in relation thereto;
- maintenance of strong balance sheet liquidity ratios and ensuring compliance with both internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- monitoring of depositor concentration both in terms of overall funding mix and to avoid undue reliance on large individual depositors;
- maintenance of liquidity contingency plans. These plans include the identification of early indicators of liquidity stress conditions and actions which are to be taken to improve the liquidity position at this stage, together with the actions which the entity can take to maintain liquidity in a crisis situation while minimising the long-term impact on its business.

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's overall funding. The group places considerable importance on the stability of these deposits, which is achieved through the group's retail banking activities and by maintaining depositor confidence in the group's capital strength. Professional markets are accessed for the purposes of providing additional funding, maintaining a presence in local money markets and optimising asset and liability maturities.

A maturity analysis of assets and liabilities is disclosed in Note 37.

50 Risk Management *(continued)*

(iii) Market risk management

Market risk is the risk that movements in foreign exchange rates, interest rates, credit spreads, or equity and commodity prices will result in profits or losses to the group. Market risk arises on financial instruments which are measured at fair value and those which are measured at amortised cost. The objective of market risk management is to control market risk exposures to achieve an optimal return while maintaining risk at acceptable levels.

The group monitors market risk separately for trading portfolios and non-trading portfolios. Trading portfolios include positions arising from market-making in exchange rate, interest rate, and equity derivative instruments, as well as in debt and equity securities. Trading risks arise either from customer-related business or from proprietary position-taking.

The management of market risk is principally undertaken in Global Markets through risk limits approved by the group's Executive Committee. Traded Markets Development and Risk, an independent unit within the Corporate, Investment Banking and Markets operation, develops risk management policies and measurement techniques, and reviews limit utilisation on a daily basis.

Risk limits are determined for each location and, within location, for each portfolio. Limits are set by product and risk type with market liquidity being a principal factor in determining the level of limits set. Limits are set using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value at risk limits at a portfolio level. Similarly, option risks are controlled through full revaluation limits in conjunction with limits on the underlying variables that determine each option's value.

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence (for the group, 99%). VAR is calculated daily.

The group uses a historical simulation model which derives plausible future scenarios from historical market data, taking account of inter-relationships between different markets and rates, for example, between interest rates and foreign exchange rates. Potential movements in market prices are calculated with reference to market data from the last two years. The model used in 2005 assumes a 1-day holding period, as this reflects the way the risk positions are managed.

Prior to 2005, the group calculated VAR on a variance/covariance basis with a holding period of 10 days. The group considers that the historical simulation model now in use better reflects actual market rate movements that occurred in the past and covers a wider diversity of risks.

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

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

The group recognises these limitations by augmenting the VAR limits with other position and sensitivity limit structures, as well as with stress testing, both on individual portfolios and on a consolidated basis. The group's stress testing regime provides senior management with an assessment of the impact of extreme events on the market risk exposures of the group.

Notes on the Accounts (continued)**50 Risk Management** (continued)

Trading

Market risk in trading portfolios is monitored and controlled at both portfolio and position levels using a complementary set of techniques such as VAR and present value of a basis point change in interest rates, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

Non-trading

The principal objective of market risk management of non-trading portfolios is to optimise net interest income.

Market risk in non-trading portfolios arises principally from mismatches between future yield on assets and their funding cost as a result of interest rate changes. Analysis of this risk involves making assumptions on optionality in certain areas, for example, mortgage prepayments, and from other behavioural variables. The market risk in non-trading portfolios is transferred to Global Markets or to separate books managed by the local Asset and Liability Management Committee ('ALCO').

Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

The group's management of market risk in non-trading portfolios also involves monitoring the sensitivity of projected net interest income under varying interest rate scenarios. The objective is to mitigate the impact of prospective interest rate movements which could reduce future net interest income while balancing the cost of such hedging activities on the current net revenue stream.

The total VAR for Global Markets was as follows:

	<i>Group</i>		<i>Bank</i>	
	2005 HK\$m	2004 HK\$m	2005 HK\$m	2004 HK\$m
Total VAR				
Year end	129	479	85	368
Average	438	454	285	339
Maximum	829	661	582	498
Minimum	69	308	69	212
Total interest rate VAR				
Year end	127	474	83	362
Average	438	447	284	331
Maximum	826	656	579	494
Minimum	71	299	69	205
Trading VAR				
Year end	31	78	33	78
Average	58	87	59	78
Maximum	113	132	112	115
Minimum	21	66	22	60
Foreign exchange trading VAR				
Year end	8	69	10	68
Average	23	79	23	70
Maximum	89	126	89	109
Minimum	3	60	3	55

50 Risk Management (continued)

	<i>Group</i>		<i>Bank</i>	
	2005	2004	2005	2004
	HK\$m	HK\$m	HK\$m	HK\$m
Interest rate trading VAR				
Year end	32	37	33	37
Average	49	34	49	34
Maximum	113	88	112	85
Minimum	20	14	23	14

Structural foreign exchange exposure

The group's gross structural foreign currency exposure is represented by the net asset value of the group's foreign currency investments in subsidiaries, branches and associates, and the fair value of the group's long-term foreign currency equity investments.

The group's structural foreign currency exposures are managed by the group's ALCO with the primary objective of ensuring where practical, that the group's and the Bank's capital ratios are protected from the effect of changes in exchange rates. The group considers hedging structural foreign currency exposures only in limited circumstances to protect the capital ratios or the value of capital invested. Such hedging would be undertaken using forward foreign exchange contracts or by financing with borrowings in the same currencies as the functional currencies involved.

Foreign currency investments amounted to the foreign currency equivalent of HK\$73,846 million (76 per cent of shareholders' funds) at 31 December 2005, an increase of HK\$25,091 million from HK\$48,755 million (58 per cent of shareholders' funds) at 31 December 2004. Gains or losses on structural foreign currency exposures are taken to reserves. The higher amount of structural foreign currency investments is principally due to an increase in the group's strategic long-term foreign currency equity investments.

The group had the following structural foreign currency exposures which exceeded 10 per cent of the net structural foreign currency exposure in all currencies:

	<i>Group</i>	<i>Bank</i>
	HK\$m	HK\$m
At 31 December 2005		
Chinese renminbi	32,510	11,558
Indian rupees	7,979	6,763
United States dollars	11,780	10,366
	<i>Group</i>	<i>Bank</i>
	HK\$m	HK\$m
At 31 December 2004		
Australian dollars	4,911	4,593
Chinese renminbi	17,398	2,335
Indian rupees	5,808	5,305
United States dollars	7,476	6,087

Notes on the Accounts (continued)**50 Risk Management** (continued)

Non-structural positions

The group had the following non-structural foreign currency positions which exceeded 10 per cent of the net non-structural foreign currency positions in all currencies:

Group

	<i>United States dollars</i>	<i>Singapore dollars</i>	<i>Brunei dollars</i>
	HK\$m	HK\$m	HK\$m
At 31 December 2005			
Spot assets	1,229,340	107,578	5,523
Spot liabilities	(1,188,737)	(90,549)	(18,062)
Forward purchases	1,507,086	157,007	43
Forward sales	(1,558,902)	(161,647)	–
Net options position	3,361	–	–
	(7,852)	12,389	(12,496)

	<i>United States dollars</i>	<i>Singapore dollars</i>	<i>Brunei dollars</i>
	HK\$m	HK\$m	HK\$m
At 31 December 2004			
Spot assets	1,060,593	83,986	5,129
Spot liabilities	(1,042,370)	(74,193)	(15,134)
Forward purchases	1,471,800	104,625	–
Forward sales	(1,490,489)	(104,339)	–
Net options position	(707)	–	–
	(1,173)	10,079	(10,005)

Bank

	<i>United States dollars</i>	<i>Singapore dollars</i>	<i>Brunei dollars</i>
	HK\$m	HK\$m	HK\$m
At 31 December 2005	(10,106)	12,388	(12,496)
At 31 December 2004	(1,336)	10,079	(10,005)

51 Ultimate holding company

The ultimate holding company of the Bank is HSBC Holdings plc, which is incorporated in England.

The largest group in which the accounts of the Bank are consolidated is that headed by HSBC Holdings plc. The consolidated accounts of HSBC Holdings plc are available to the public on the Group's web site at www.hsbc.com or may be obtained from 8 Canada Square, London E14 5HQ, United Kingdom.

52 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 6 March 2006.

Auditors' Report to the Shareholders of The Hongkong and Shanghai Banking Corporation Limited (incorporated in the Hong Kong SAR with limited liability)

We have audited the accounts on pages 21 to 152 which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective Responsibilities of Directors and Auditors

The Hong Kong Companies Ordinance requires the Directors to prepare accounts which give a true and fair view. In preparing accounts which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently, that judgements and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

It is our responsibility to form an independent opinion, based on our audit, on those accounts and to report our opinion solely to you, as a body, in accordance with section 141 of the Hong Kong Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the circumstances of the Bank and of the group, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the accounts are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the accounts. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, the accounts give a true and fair view of the state of affairs of the Bank and of the group as at 31 December 2005 and of the profit and cash flows of the group for the year then ended and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

KPMG

Certified Public Accountants
Hong Kong, 6 March 2006

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