

The Hongkong and Shanghai Banking Corporation Limited

Annual Report and Accounts 2017

Contents

	Page
Certain defined terms	1
Cautionary statement regarding forward-looking statements	1
Chinese translation	1
Financial Highlights	2
Report of the Directors	3
Financial Review	9
Risk	12
Capital	34
Statement of Directors' Responsibilities	38
Auditor's Report	39

Certain defined terms

This document comprises the *Annual Report and Accounts 2017* for The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group'). References to 'HSBC', 'the Group' or 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the People's Republic of China is referred to as 'Hong Kong'. The abbreviations 'HK\$m' and 'HK\$bn' represent millions and billions (thousands of millions) of Hong Kong dollars respectively.

Cautionary statement regarding forward-looking statements

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

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

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

Chinese translation

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

本《年報及賬目》備有中譯本，如有需要可向下列部門索取：香港皇后大道中1號滙豐總行大廈32樓企業傳訊部（亞太區）。本報之中英文本亦載於本行之網站 www.hsbc.com.hk。

Financial Highlights

	2017	2016
	HK\$m	HK\$m
For the year		
Net operating income before loan impairment charges	186,443	168,152
Profit before tax	115,619	102,707
Profit attributable to shareholders	88,530	78,646
At the year-end		
Total shareholders' equity	696,480	628,006
Total equity	752,986	679,136
Total capital	522,244	491,302
Customer accounts	5,138,272	4,900,004
Total assets	7,943,346	7,548,952
Ratios		
	%	%
Return on average ordinary shareholders' equity	13.7	13.0
Post-tax return on average total assets	1.2	1.1
Cost efficiency ratio	43.5	44.5
Net interest margin	1.88	1.75
Advance-to-deposits ratio	64.8	57.8
Capital ratios		
– Common equity tier 1 capital	15.9	16.0
– Tier 1 capital	17.0	17.2
– Total capital	18.9	19.0

Established in Hong Kong and Shanghai in 1865, The Hongkong and Shanghai Banking Corporation Limited is the founding member of the HSBC Group – one of the world's largest banking and financial services organisations. It is the largest bank incorporated in Hong Kong and one of Hong Kong's three note-issuing banks. It is a wholly-owned subsidiary of HSBC Holdings plc, the holding company of the HSBC Group, which has an international network organised into five geographical regions: Europe, Asia, Middle East and North Africa, North America and Latin America.

The Hongkong and Shanghai Banking Corporation Limited

Incorporated in the Hong Kong SAR with limited liability

Registered Office and Head Office: HSBC Main Building, 1 Queen's Road Central, Hong Kong

Telephone: (852) 2822 1111 Facsimile: (852) 2810 1112 Web: www.hsbc.com.hk

Report of the Directors

Principal Activities

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

Asia Strategy

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

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

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 46 to 97.

Subordinated liabilities, Preference Shares and Share Capital

Details on subordinated liabilities issued by the group are set out in notes 25 and 35. Details on preference shares and share capital of the Bank are set out in notes 26, 27 and 28 on the Financial Statements.

Dividends

The interim dividends paid in respect of 2017 are set out in note 6 on the Financial Statements.

Directors

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

Stuart Thomson Gulliver[#]

Chairman

He is the Group Chief Executive and an executive Director of HSBC Holdings plc. He will step down from his roles in HSBC Holdings plc and as Chairman of the Bank on 20 February 2018. He holds a Master's Degree in Jurisprudence from Oxford University.

Peter Tung Shun Wong

Deputy Chairman & Chief Executive

He is a Group Managing Director and Member of the Group Management Board of HSBC Holdings plc; a non-executive Director of Hang Seng Bank Limited; Vice Chairman and non-executive Director of Bank of Communications Co., Ltd.; and an independent non-executive Director of Cathay Pacific Airways Limited. He is also the Chairman of HSBC Bank (China) Company Limited; and a Director of HSBC Bank Malaysia Berhad. He holds a Bachelor of Arts, a Master of Business Administration and a Master of Science from Indiana University.

Laura May Lung Cha*, GBM

Deputy Chairman

She is an independent non-executive Director of HSBC Holdings plc. She is also an independent non-executive Director of China Telecom Corporation Limited, Unilever PLC and Unilever N.V.. She holds a Bachelor of Arts from University of Wisconsin-Madison and a Juris Doctor from University of Santa Clara Law School. She is also admitted to practice in the State of California and in Federal Courts.

Zia Mody*

Deputy Chairman

She is a partner of AZB & Partners and an independent non-executive Director of CLP Holdings Limited. She holds a Bachelor of Arts (Law) from Cambridge University and a Master of Laws from Harvard University.

Graham John Bradley*

He is the Non-Executive Chairman and a Director of HSBC Bank Australia Limited. He is also Chairman and Non-executive Director of Graincorp Limited; Chairman and Director of EnergyAustralia Holdings Limited; Chairman of Infrastructure New South Wales and Chairman and Director of Virgin Australia International Holdings Limited. He holds a Bachelor of Arts in LLB (Hons I) from Sydney University and an LLM from Harvard University.

Louisa Wai Wan Cheang

She is the Vice-Chairman and Chief Executive of Hang Seng Bank Limited; an International Advisor of China Union Pay; and a Group General Manager of HSBC Holdings plc. She holds a Bachelor of Social Sciences from The University of Hong Kong. She is also an Honorary Certified Financial Management Planner of The Hong Kong Institute of Bankers.

Dr Christopher Wai Chee Cheng*, GBS, OBE

He is the Chairman of Wing Tai Properties Limited; an independent non-executive Director of NWS Holdings Ltd.; and an independent non-executive Director of Eagle Asset Management (CP) Limited. He holds a Bachelor of Business Administration from University of Notre Dame; a Master of Business Administration from Columbia University; a Doctorate in Social Sciences honoris causa from The University of Hong Kong and an Honorary Degree of Doctor of Business Administration from the Hong Kong Polytechnic University.

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

He is independent non-executive Chairman of Hang Seng Bank Limited. He is also an independent non-executive Director of China Resources Power Holdings Company Limited, Swiss Re Limited and Swiss Re Asia Pte. Ltd. He holds a Bachelor of Arts from Rockford College and a Master of Arts and Doctor of Philosophy (Economics) from University of Pennsylvania.

Yiu Kwan Choi*

He is an independent Non-Executive Director of HSBC Bank (China) Company Limited. He holds a higher certificate in Accountancy from Hong Kong Polytechnic University and is a Fellow Member of The Hong Kong Institute of Bankers.

He was the Deputy Chief Executive of the Hong Kong Monetary Authority ('HKMA') in charge of Banking Supervision when he retired in January 2010. Before this, he was Deputy Chief Executive of the HKMA in charge of Monetary Policy and Reserves Management from June 2005 to August 2007 and held various senior positions in the HKMA including Executive Director (Banking Supervision), Head of Administration, and Head of Banking Policy from 1993 to 2005.

John Michael Flint[#]

He is the Group Chief Executive Designate of HSBC Holdings plc. He will succeed Stuart Gulliver as Chairman of the Bank and as Group Chief Executive and executive Director of HSBC Holdings plc effective from 21 February 2018. He holds a Bachelor of Arts (Hons) in Economics from Portsmouth Polytechnic.

His previous roles with the Group include: Chief Executive of Retail Banking and Wealth Management, Chief of Staff to the Group Chief Executive and Group Head of Strategy and Planning, Chief Executive Officer of Global Asset Management and Group Treasurer and Deputy Head of Global Markets.

Irene Yun-lien Lee*

She is the executive Chairman of Hysan Development Company Limited and an independent non-executive Director of Hang Seng Bank Limited, Cathay Pacific Airways Limited and CLP Holdings Limited. She holds a Bachelor of Arts (Distinction) in History of Art from Smith College, Northampton, Massachusetts, USA. She is also a member of the Honourable Society of Gray's Inn, UK and a Barrister-at-Law in England and Wales.

Jennifer Xinzhe Li*

She is the Chief Executive Officer and General Partner of Baidu Capital, having previously been the Chief Financial Officer of Baidu, Inc. and is also an independent non-executive Director of Philip Morris International Inc. She holds a Bachelor of Arts from Tsinghua University and a Master of Business Administration from University of British Columbia.

Victor Tzar Kuoi Li[#]

He is the Managing Director and Deputy Chairman and an Executive Director of CK Asset Holdings Limited; the Group Co-Managing Director and Deputy Chairman of CK Hutchison Holdings Limited; the Chairman of CK Infrastructure Holdings Limited and CK Life Sciences Int'l., (Holdings) Inc.; a Non-executive Director of Power Assets Holdings Limited and HK Electric Investments Manager Limited; a Non-executive Director and the Deputy Chairman of HK Electric Investments Limited; and Co-Chairman of Husky Energy Inc. He is also the Deputy Chairman of Li Ka Shing Foundation Limited, Li Ka Shing (Overseas) Foundation and Li Ka Shing (Canada) Foundation. He holds a Bachelor of Science degree in Civil Engineering, a Master of Science degree in Civil Engineering, both received from Stanford University; and an honorary degree, Doctor of Laws, honoris causa (LL.D.) from The University of Western Ontario.

Bin Hwee Quek (née Chua)*

She is an independent non-executive Director of CapitaLand Commercial Trust Management Limited and Mapletree Oakwood Holdings Pte. Ltd. She is also a Director of several government organisations in Singapore, including Duke-NUS Graduate Medical School, Health Promotion Board, Maritime and Port Authority of Singapore, and National Heritage Board. She chairs four Audit Committees.

She was an audit partner with Price Waterhouse Singapore and later, PricewaterhouseCoopers (PwC) Singapore, for 26 years. A member of the PwC Singapore and PwC Asia leadership teams, she held many leadership positions including Vice Chairman of PwC Singapore and Deputy Markets Leader of PwC Asia Pacific and Americas. She holds a Bachelor of Accountancy (Hons) from The University of Singapore and is a Chartered Accountant with the Institute of Singapore Chartered Accountants.

John Robert Slosar*

He is the Chairman and a Director of Cathay Pacific Airways Limited, Swire Pacific Limited, John Swire & Sons (H.K.) Limited and Swire Properties Limited; the Chairman and Executive Director of Hong Kong Aircraft Engineering Company Limited; and a non-executive Director of Air China Limited. He holds a Bachelor in Economics from Columbia University and a Bachelor in Economics and M.A. from the University of Cambridge.

Kevin Anthony Westley*, BBS

He is an independent Non-executive Director of Hutchison Port Holdings Management Pte. Ltd. and Fu Tak Lam Foundation Limited and a member of the investment committee of The West Kowloon Cultural Development Authority. He holds a Bachelor of Arts (Hons) from the University of London (LSE) and is a Fellow of the Institute of Chartered Accountants in England and Wales. He was the Chairman (from 1996) and Chief Executive (from 1992) of HSBC Investment Bank Asia Limited (formerly named as Wardley Limited) until his retirement in 2000 and subsequently acted as an advisor to the Bank and the Group in Hong Kong.

Marjorie Mun Tak Yang*, GBS

She is the Chairman of Esquel Holdings Inc. She holds a B.Sc. in Mathematics from Massachusetts Institute of Technology; and a Master of Business Administration from Harvard Business School.

Tan Sri Dr Francis Sock Ping Yeoh*, CBE

He is Managing Director of YTL Corporation Berhad, YTL E-Solutions Berhad, YTL Land & Development Berhad and YTL Power International Berhad. He holds a Bachelor of Science (Hons) in Civil Engineering and an Honorary Doctorate of Engineering from the University of Kingstons.

* Independent non-executive Director
Non-executive Director

During the year, Rosanna Wong retired on 24 April 2017 and Rose Lee resigned on 1 July 2017. Louisa Cheang was appointed on 14 September 2017, Yiu Kwan Choi was appointed on 3 October 2017 and Bin Hwee Quek was appointed on 14 November 2017. John Flint was appointed on 16 January 2018. Save for the above, all the Directors served throughout the year.

A list of the directors of the Bank's subsidiary undertakings (consolidated in the financial statements) during the period from 1 January 2017 to the date of this report will be available on the Bank's website <https://www.personal.hsbc.com.hk/1/2/hk/regulatory-disclosures>.

Secretary

The Board has resolved that Neil Olofsson will succeed Paul Stafford as Corporation Secretary with effect from 1 April 2018.

Permitted Indemnity Provision

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

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

Directors' Interests in Transactions, Arrangements or Contracts

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

Directors' Rights to Acquire Shares or Debentures

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

Executive Directors of the Bank and those executive Directors of HSBC Holdings plc are eligible to receive an annual incentive award based on the outcome of the performance measures set out in their annual performance scorecard. Annual incentive awards are normally delivered in cash and/or shares; these generally have a deferral rate of 60% or 40% if the annual incentive award is GBP500,000 or below. The period of which the annual incentive award would be deferred is determined in accordance with the requirements of the Prudential Regulation Authority ('PRA') Remuneration Rules, i.e. seven years for Senior Managers (individuals in PRA and Financial Conduct Authority ('FCA') designation Senior Management Functions), five years for Risk Managers, and three years for other Material Risk Takers ('MRTs'). From January 2017 onwards, all share awards granted to MRTs are subject to a minimum retention period of one year as opposed to six months previously. However, for certain individuals whose variable pay awards will be deferred for at least five years and who are not considered to be members of senior management, their retention period may be kept at six months.

All unvested deferred awards made under the HSBC Share Plan 2011 are subject to the application of malus, i.e. the cancellation and reduction of unvested deferred awards. All paid or vested variable pay awards made to Identified Staff and MRTs will be subject to clawback for a period of seven years from the date of award. For Senior Managers, this may be extended to 10 years in the event of an ongoing internal or regulatory investigation at the end of the seven-year period.

Executive Directors and other senior executives are subject to minimum shareholding requirements. Individuals are given five years from 2014 or (if later) their appointment to build up the recommended levels of shareholding. HSBC operates an anti-hedging policy; all employees including executive Directors are required to certify each year that they have not entered into any personal hedging strategies in relation to their holdings of HSBC shares.

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

continued employment with HSBC and retention of the Investment Shares until the third anniversary of the start of the relevant plan year.

During the year, Stuart Gulliver, Peter Wong, Louisa Cheang and Rose Lee acquired or were awarded shares of HSBC Holdings plc under the terms of the HSBC Share Plan 2011. Apart from these arrangements, at no time during the year was the Bank, its holding companies, its subsidiaries or any fellow subsidiaries a party to any arrangements to enable the Directors to acquire benefits by means of the acquisition of shares in or debentures of the Bank or any other body corporate.

Donations

Donations made by the Bank and its subsidiaries during the year amounted to HK\$386m (2016: HK\$344m).

Compliance with the Banking (Disclosure) Rules

The Directors are of the view that the *Annual Report and Accounts 2017* and Banking Disclosure Statements 2017, which will be published separately, fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance.

Auditor

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

Corporate Governance

The Bank is committed to high standards of corporate governance. As an Authorised Institution, the Bank is subject to and complies with the Hong Kong Monetary Authority ('HKMA') Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions'.

Board of Directors

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

Directors

The Bank has a unitary Board. The authority of each Director is exercised in Board meetings where the Board acts collectively. As at 20 February 2018, the Board comprised the Chairman, Deputy Chairman and Chief Executive, two Deputy Chairmen who are independent non-executive Directors, one Director with executive responsibilities for a subsidiary's operations, two non-executive Directors and another 11 independent non-executive Directors.

Independent non-executive Directors

Independent non-executive Directors do not participate in the daily business management of the Bank. They bring an external perspective, constructively challenge and help develop proposals on strategy, scrutinise the performance of management in meeting agreed goals and objectives, and monitor the risk profile and reporting of performance of the Bank. The independent non-executive Directors bring experience from a number of industries and business sectors, including the leadership of large complex multinational enterprises. The Board has determined that there are 13 independent non-executive Directors. In making this determination, it was agreed that there are no relationships or circumstances likely to affect the judgement of the independent non-executive Directors, with any relationships or circumstances that could appear to do so not considered to be material.

Chairman and Chief Executive

The roles of Chairman and Chief Executive are separate and held by experienced full-time employees of the HSBC Group. There is a

clear division of responsibilities between leading the Board and the executive responsibility for running the Bank's business.

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

Board Committees

The Board has established various committees consisting of Directors and senior management. The committees include the Executive Committee, Audit Committee, Risk Committee, Nomination Committee, Remuneration Committee and Chairman's Committee. The chairmen of the Executive Committee and of each Board committee that includes independent non-executive Directors reports to each subsequent Board meeting on the relevant committee's proceedings.

The Board has also established an Asset and Liability Management Committee, a Risk Management Meeting and a Financial Crime Risk Management Committee. The Executive Committee has the delegated authority to approve any changes in the membership and terms of reference of the Asset and Liability Management Committee, Risk Management Meeting and the Financial Crime Risk Management Committee. Furthermore, the Board has also established Financial System Risk Advisory Committees for North Asia and South Asia as sub-committees of the Risk Committee. The Risk Committee has the delegated authority to approve any changes in the membership and terms of reference of these two sub-committees.

The Board and each Board committee have terms of reference to document their responsibilities and governance procedures. The key roles of the committees are described in the paragraphs below.

Executive Committee

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

The Bank's Deputy Chairman and Chief Executive, Peter Wong, is Chairman of the Committee. The current members of the Committee are: Diana Cesar (Chief Executive Officer Hong Kong), Pui Mun Chan (Head of Regulatory Compliance Asia-Pacific), Raymond Cheng (Chief Operating Officer Asia-Pacific), Gordon French (Head of Global Banking and Markets Asia-Pacific), Kathleen Gan (Chief Financial Officer Asia-Pacific), Tony Cripps (Chief Executive Officer Singapore), Mukhtar Hussain (Chief Executive Officer Malaysia), Darren Furnarello (Head of Financial Crime Compliance, Asia-Pacific), David Liao (Chief Executive Officer China), Kevin Martin (Regional Head of Retail Banking and Wealth Management Asia-Pacific), Mark McKeown (Chief Risk Officer, Asia-Pacific), Jayant Rikhye (Chief Executive Officer India), Siew Meng Tan (Regional Head of Global Private Banking Asia-Pacific), Matthew Lobner (Head of Strategy and Planning, Asia-Pacific and Head of International Asia-Pacific), Susan Sayers (Regional General Counsel, Asia-Pacific), Stuart Tait (Regional Head of Commercial Banking, Asia-Pacific), Donna Wong (Head of Human Resources Asia-Pacific), Helen Wong (Chief Executive Officer Greater China). Paul Stafford (Corporation Secretary) is the Committee Secretary. In attendance are: Kaber Mclean (Head of Remediation Management Office, Asia-Pacific), Malcolm Wallis (Head of Communications Asia-Pacific), Martin Tricaud (Chief Executive Officer Australia) and Philip Miller (Senior Assistant Company Secretary). The Committee met 12 times in 2017.

Asset and Liability Management Committee

The Asset and Liability Management Committee is chaired by the Chief Financial Officer and is an advisory committee to provide recommendations and advice to support the Chief Financial Officer's individual accountability for issues and risks with regards to capital, liquidity risk, funding risk, interest rate risk in the banking book, structural foreign exchange risk and structural/strategic equity risk. The Committee consists of Peter Wong, the Bank's Deputy Chairman and Chief Executive, the Head of Asset, Liability and Capital Management, Asia-Pacific, the Head of Balance Sheet Management, Asia-Pacific and other senior executives of the Bank, most of whom are members of the Executive Committee. The Committee met 12 times in 2017.

Risk Management Meeting

The Risk Management Meeting is chaired by the Chief Risk Officer and is a formal governance committee established to provide recommendations and advice requested to the Chief Risk Officer on enterprise-wide management of all risks and the policies and guidelines for the management of risk within the Bank. The Meeting consists of Peter Wong, the Bank's Deputy Chairman and Chief Executive, the Head of Global Internal Audit, Asia-Pacific and other senior executives of the Bank, most of whom are members of the Executive Committee. The Committee met 12 times in 2017.

Financial Crime Risk Management Committee

The Financial Crime Risk Management Committee, established in August 2017, is chaired by the Bank's Deputy Chairman and Chief Executive and is a formal governance committee established to ensure effective enterprise-wide management of financial crime risk within the Asia-Pacific Region and to support the Chief Executive Officer in discharging his financial crime risk responsibilities. The Committee consists of the Regional Head of Financial Crime Compliance, Asia-Pacific, the Regional Head of Financial Crime Threat Mitigation, Asia-Pacific, the Regional Head of Operational Risk, Asia-Pacific, the Regional Reputational Risk and Client Selection Lead, Asia-Pacific, the Regional Head of Remediation Office, Asia-Pacific, the Regional Global Standards Execution Lead, Asia-Pacific, the Head of Global Internal Audit, Asia-Pacific, the Regional Head of Financial Crime Risk Chief Operating Officer, Asia-Pacific and other senior executives of the Bank, most of whom are members of the Executive Committee. The Committee met five times in 2017.

Audit Committee

The Audit Committee has non-executive responsibility for oversight of and advice to the Board on matters relating to financial reporting.

The current members of the Committee, all being independent non-executive Directors, are Kevin Westley (Chairman of the Committee), Graham Bradley, Choi Yiu Kwan, Irene Lee and Jennifer Li. The Committee met five times in 2017.

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

Risk Committee

The Risk Committee has non-executive responsibility for oversight of and advice to the Board on high-level risk-related matters and risk governance. The current members of the Committee, all being independent non-executive Directors, are Graham Bradley (Chairman of the Committee), Dr Christopher Cheng, Choi Yiu

Kwan, Irene Lee, Zia Mody and Kevin Westley. The Committee met five times in 2017.

A Financial System Risk Advisory Committee for South Asia (formerly named the Financial System Vulnerabilities Committee for India) was established by the Board as a sub-committee of the Risk Committee on 1 January 2017. The Committee is responsible for the review, monitoring and advice on the effectiveness of the policies, procedures and the controls framework established relating to financial crime and financial system abuse risks specific to South Asia (i.e. India, Bangladesh, Mauritius and Sri Lanka). The current members of the Committee, all being external professional advisors, are Nehchal Sandhu (Chairman of the Committee), Nicholas Langman and Richard Boucher. The Chairman of the Committee is a member of the HSBC Holdings plc Financial System Vulnerabilities Committee. The Committee met five times in 2017.

A Financial System Risk Advisory Committee for North Asia was established by the Board as a sub-committee of the Risk Committee on 15 June 2017. The Committee is responsible for the review, monitoring and advice on the effectiveness of the policies, procedures and the controls framework established relating to financial crime and financial system abuse risks specific to North Asia (i.e. mainland China, Hong Kong, Taiwan, Macau, Japan and Korea). The current members of the Committee are David Irvine (Chairman of the Committee) and Ambrose Lee, both being external professional advisors, and Choi Yiu Kwan, who is an independent non-executive Director of the Bank. The Chairman of the Committee is a member of the HSBC Holdings plc Financial System Vulnerabilities Committee. The Committee met two times in 2017.

All of the Bank's activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks. The Board, advised by the Risk Committee, requires and encourages a strong risk culture which shapes the Bank's attitude to risk. The Bank's risk governance is supported by the Group's enterprise-wide risk management framework which provides a clear policy of risk ownership and accountability of all staff for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by clear and consistent employee communication on risk that sets the tone from senior leadership, the governance structure, mandatory learning and remuneration policy, helps to foster a disciplined and constructive culture of risk management and control throughout the group.

The Board and the Risk Committee oversee the maintenance and development of a strong risk management framework by continually monitoring the risk environment, top and emerging risks facing the group and mitigating actions planned and taken. The Risk Committee recommends the approval of the group's risk appetite statement to the Board and monitors performance against the key performance/risk indicators included within the statement. The Risk Committee monitors the risk profiles for all of the risk categories within the group's business. The Committee also monitors the effectiveness of the Bank's risk management and internal controls, including operational and compliance controls, and risk management systems. Regular reports from the Risk Management Meeting, which is the executive body responsible for overseeing risk, are also presented at each Risk Committee meeting to report on these items.

Nomination Committee

The Nomination Committee is responsible for leading the process for Board and senior management appointments and for identifying and nominating, for the approval of the Board, candidates for appointment to the Board and certain senior management roles. Appointments to the Board are subject to the approval of the HKMA. The Committee considers plans for orderly succession to the Board and the appropriate balance of skills and experience on the Board.

The current members of the Committee, being a majority of independent non-executive Directors, are Marjorie Yang (Chairman of the Committee), Stuart Gulliver (Chairman of the Board) and Laura Cha. The Deputy Chairman and Chief Executive attends

each meeting of the Committee. The Committee met two times in 2017.

A rigorous selection process, overseen by the Nomination Committee and based upon agreed requirements using an external search consultancy, is followed in relation to the appointment of non-executive Directors. Before recommending an appointment of a Director to the Board, the Committee evaluates the Board composition including balance of skills, knowledge and experience, as well as diversity and the role and capabilities required. In identifying suitable Board candidates, the Committee considers candidates' backgrounds, knowledge and experience (including international experience) to promote diversity of views, and takes into account the required time commitment and any potential conflicts of interest.

During the year, the Nomination Committee made recommendations to the Board for the appointments of Louisa Cheang, Yiu Kwan Choi, Bin Hwee Quek and John Flint.

Chairman's Committee

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

The current members of the Committee comprise the Chairman of the Board, the Deputy Chairman and Chief Executive, the non-executive Deputy Chairmen and the Chairmen of the Audit and Risk Committees. The Committee met three times in 2017.

Remuneration Committee

Following revisions to the HKMA's Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions (AI)', the Board approved the establishment of a Remuneration Committee with effect from 1 January 2018. The new Committee will review and approve remuneration matters for the performance year 2018 onwards. The current members of the Committee, all being independent non-executive Directors, are Irene Lee (Chairman of the Committee), Marjorie Yang, Christopher Cheng, Jennifer Li and Bin Hwee Quek. The Committee held its first meeting in January 2018.

Before the establishment of the Remuneration Committee and the revisions to the HKMA Supervisory Policy Manual, it was acceptable for the Group Remuneration Committee established by the ultimate holding company, HSBC Holdings plc, to assist the Board in discharging its responsibilities for remuneration matters. The Group Remuneration Committee, comprising independent non-executive Directors, is responsible for setting the principles, parameters and governance framework for the Group's remuneration policy applicable to all Group employees. It oversees the application of the policy to the wider employee population, including employees in subsidiaries and branches, subject to local regulations. It is also responsible for assessing that there are effective safeguards in place to ensure that remuneration policies are clearly aligned with the Group's risk appetite and the regulatory requirements that the Group is required to comply with.

Remuneration Strategy

Our remuneration strategy is designed to reward competitively the achievement of long-term sustainable performance, and attract and motivate the very best people who are committed to maintaining a long-term career with the Group while performing their role in the long-term interests of our stakeholders. We believe that remuneration is an important tool for instilling the right behaviours and driving and encouraging actions that are aligned to organisational values and expectations.

Our remuneration strategy as approved by the Group Remuneration Committee is based on the following principles:

- An alignment to performance at all levels (individual, business and Group) taking into account both 'what' has been achieved and 'how' it has been achieved. The 'how' helps ensure that performance is sustainable in the longer term against HSBC's values, conduct and risk and compliance standards.
- Being informed, but not driven by, market position and practice. Market benchmarks are sourced through independent specialists and provide an indication of the range of pay levels and employee benefits provided by our competitors.
- Targeting pay for employees across the full market range depending upon their individual performance and that of the Group. An individual's position in this market range will also vary depending upon their performance in any given year.
- Compliance with relevant regulation across all of our countries and territories.

The Bank's remuneration strategy is aligned to the Group's remuneration strategy, the details of which are contained within the *Annual Report and Accounts 2017* of HSBC Holdings plc.

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

Banking structural reform and recovery and resolution planning

Globally there have been a number of developments relating to banking structural reform and the introduction of recovery and resolution regimes, sometimes referred to as 'living wills' for banks. As part of the regime, banks are working with regulators to establish legal and operating structures which can allow them to be resolved in an orderly manner in the event of failure, minimising disruption to financial stability and the risk to public funds.

In Hong Kong, the Financial Institutions (Resolution) Ordinance ('FIRO') was passed by the Legislative Council in 2016 and came into effect in Hong Kong on 7 July 2017. The FIRO establishes the legal basis for a resolution regime in Hong Kong to mitigate the risks posed by the failure of systemically important financial institutions to the stability and effective working of the Hong Kong financial system.

Internationally, the Group is working with our primary regulators to develop and agree a resolution strategy for the Group. In Hong Kong, under the FIRO, there are a number of options available to regulators for implementing an orderly resolution of a failed bank. These options include a bail-in stabilisation option, which will allow regulators to recapitalise a failing bank by imposing losses on its shareholders and certain creditors, thereby stabilising and restoring it to viability. Banks need to have sufficient loss-absorbing capacity ('LAC'), which can be written down or converted into equity in the event of failure to ensure the effective use of the bail-in option. Details on LAC requirements and operations of bail-in in Hong Kong are expected to be further progressed in 2018.

For the group, the preferred resolution strategy is a bail-in at an intermediate holding company ('IHC') level in Hong Kong to recapitalise the group as a whole. The IHC in Hong Kong will be the resolution entity for the group, whereby adequate LAC will be available in a form that will be bailed in at the point of resolution. An IHC was incorporated in Hong Kong as a direct subsidiary of HSBC Holdings plc in 2017, with the transfer of the group to the IHC expected to progress during 2018. This is an internal legal entity restructuring and will not impact the business and management of the group.

In addition, similar to all Global Systemically Important Banks ('G-SIBs'), the Group is working with our regulators to mitigate or remove critical inter-dependencies between our subsidiaries to further facilitate the resolution of the Group. In particular, in order to remove operational dependencies (where one subsidiary bank provides critical services to another), the Group is in the process of transferring critical services from our subsidiary banks to a separate internal group of service companies ('ServCo group'). In 2017, the HBAP group began to transfer certain properties and employees in Hong Kong to the ServCo group, which is not a subsidiary of HBAP but of HSBC Holdings plc. There were no changes to employment terms and conditions or pension benefits as a result of these transfers. Transfers of additional employees, critical shared services and assets in Hong Kong are expected to progress in 2018.

Business review

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

On behalf of the Board

Stuart Gulliver, Chairman

20 February 2018

Financial Review

Results for 2017

Profit before tax for 2017 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') increased by HK\$12,912m, or 13%, to HK\$115,619m.

Consolidated income statement and balance sheet data by global business

(Audited)

	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Corporate Centre ¹	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Year ended 31 Dec 2017						
Net interest income	50,789	31,237	19,147	1,868	7,196	110,237
Net fee income	20,695	10,443	9,936	1,916	160	43,150
Net trading income	2,056	2,976	16,161	963	1,054	23,210
Net income/(expense) from financial instruments designated at fair value	15,903	(416)	19	–	(126)	15,380
Gains less losses from financial investments	149	64	1	–	1,894	2,108
Dividend income	36	1	–	–	195	232
Net insurance premium income/(expense)	53,275	2,933	–	–	(32)	56,176
Other operating income	1,488	336	189	51	2,676	4,740
Total operating income	144,391	47,574	45,453	4,798	13,017	255,233
Net insurance claims and benefits paid and movement in liabilities to policyholders	(65,941)	(2,849)	–	–	–	(68,790)
Net operating income before loan impairment charges and other credit risk provisions	78,450	44,725	45,453	4,798	13,017	186,443
Loan impairment (charges)/releases and other credit risk provisions	(1,907)	(2,157)	(451)	(2)	80	(4,437)
Net operating income	76,543	42,568	45,002	4,796	13,097	182,006
Operating expenses	(34,807)	(16,115)	(20,653)	(2,679)	(6,813)	(81,067)
Operating profit	41,736	26,453	24,349	2,117	6,284	100,939
Share of profit in associates and joint ventures	86	–	–	–	14,594	14,680
Profit before tax	41,822	26,453	24,349	2,117	20,878	115,619
Balance at 31 Dec 2017						
Net loans and advances to customers	1,049,006	1,143,241	1,004,350	115,064	17,319	3,328,980
Customer accounts	2,701,399	1,311,873	905,991	187,825	31,184	5,138,272
Year ended 31 Dec 2016						
Net interest income	43,632	26,945	17,367	1,444	7,520	96,908
Net fee income	17,949	10,355	9,502	1,278	218	39,302
Net trading income	1,377	2,450	17,168	1,007	2,062	24,064
Net income/(expense) from financial instruments designated at fair value	3,591	(276)	91	–	164	3,570
Gains less losses from financial investments	335	249	33	–	615	1,232
Dividend income	67	1	–	–	166	234
Net insurance premium income/(expense)	52,954	3,004	–	–	(46)	55,912
Other operating income	7,792	473	1,143	15	2,093	11,516
Total operating income	127,697	43,201	45,304	3,744	12,792	232,738
Net insurance claims and benefits paid and movement in liabilities to policyholders	(61,280)	(3,306)	–	–	–	(64,586)
Net operating income before loan impairment charges and other credit risk provisions	66,417	39,895	45,304	3,744	12,792	168,152
Loan impairment (charges)/releases and other credit risk provisions	(2,133)	(2,469)	(874)	4	(82)	(5,554)
Net operating income	64,284	37,426	44,430	3,748	12,710	162,598
Operating expenses	(32,520)	(14,971)	(19,413)	(2,332)	(5,567)	(74,803)
Operating profit	31,764	22,455	25,017	1,416	7,143	87,795
Share of profit in associates and joint ventures	148	–	–	–	14,764	14,912
Profit before tax	31,912	22,455	25,017	1,416	21,907	102,707
Balance at 31 Dec 2016						
Net loans and advances to customers	936,310	996,772	791,522	91,574	17,936	2,834,114
Customer accounts	2,537,128	1,286,368	857,583	192,163	26,762	4,900,004

¹ Includes inter-segment elimination

Results Commentary

(Unaudited)

The group reported profit before tax of HK\$115,619m, an increase of 13% compared with 2016, driven by higher net interest income, higher net fee income and higher income (net of claims) from insurance business.

Net interest income increased by HK\$13,329m, or 14%, compared with 2016, driven by Hong Kong mainly from wider customer deposit spreads and higher yields on financial investments, which benefited from interest rate rises since late 2016, coupled with balance sheet growth, mainly in loans and advances to customers.

Net fee income increased by HK\$3,848m, or 10%, compared with 2016, mainly in Hong Kong from higher securities brokerage, unit trust and funds under management due to higher turnover from favourable equity market sentiment in 2017, and to a lesser extent from higher mandatory provident fund and underwriting fees.

Net trading income decreased by HK\$854m, or 4%, driven by mainland China from foreign exchange translation losses on foreign currency denominated financial assets, higher interest expense and revaluation losses on structured deposits, coupled with higher revaluation losses on foreign currency funding swaps. The decrease in net trading income was also due to unfavourable valuation adjustments on derivative contracts from the narrowing of own credit spreads, mainly in Hong Kong and Australia. These were partly offset by higher net trading income in insurance business in Hong Kong, mainly from the favourable revaluation of foreign currency swaps. Net trading income in Taiwan also increased, mainly from higher revaluation gains on foreign currency funding swaps.

Net income from financial instruments designated at fair value increased by HK\$11,810m, driven by revaluation gains on the equity portfolio held by the insurance business in Hong Kong from strong equity market performance in 2017. To the extent that investment returns are attributable to policyholders, there is an

Net interest income

(Unaudited)

	2017 HK\$m	2016 HK\$m
Net interest income	110,237	96,908
Average interest-earning assets	5,850,010	5,527,461
Net interest margin	%	%
Spread	1.80	1.67
Contribution from net free funds	0.08	0.08
Total	1.88	1.75

Net interest income ('NII') increased by HK\$13,329m, or 14% compared with 2016, driven by Hong Kong mainly from wider customer deposit spreads and higher yields on financial investments, which benefited from interest rate rises since late 2016, coupled with balance sheet growth, mainly in loans and advances to customers. NII also increased in mainland China from balance sheet growth, higher re-investment yields on financial investments, coupled with lower cost of funds, in Australia from balance sheet growth and lower cost of funds, and in Singapore mainly from balance sheet growth.

Average interest-earning assets increased by HK\$323bn, or 6%, compared with 2016, driven by Hong Kong mainly due to an increase in loans and advances to customers, notably in corporate term lending and mortgages.

Net interest margin increased by 13 basis points compared with 2016, driven by Hong Kong, although increases were also noted in mainland China and Australia.

In **Hong Kong**, the net interest margin for the Bank increased by 14 basis points, mainly due to wider customer deposit spreads and higher re-investment yields on financial investments following interest rate increases, coupled with a change in asset portfolio

offsetting movement reported under 'Net insurance claims and benefits paid and movement in liabilities to policyholders'.

Gains less losses from financial investments increased by HK\$876m, mainly reflecting the gain on disposal of our available-for-sale investment in Vietnam Technological and Commercial Joint Stock Bank ('Techcom Bank').

Other operating income decreased by HK\$6,776m, driven by lower favourable movements in the present value of in-force insurance business, mainly in Hong Kong and Singapore due to unfavourable actuarial assumption updates. This was partly offset by higher gains from the revaluation of investment properties.

Net insurance claims and benefits paid and movement in liabilities to policyholders increased by HK\$4,204m, reflecting higher investment returns to policyholders due to strong equity market performance in 2017, partly offset by the impact from lower favourable movements in the present value of in-force business.

Loan impairment charges and other credit risk provisions decreased by HK\$1,117m, or 20%, with decreases across various countries, notably in Singapore from impairment releases in CMB, in India mainly from the non-recurrence of impairment charges in GB&M, coupled with releases in CMB, in mainland China from lower impairment charges mainly in CMB, and in Australia mainly due to the non-recurrence of a charge in GB&M. These were partly offset by higher impairment charges in Hong Kong, mainly in CMB.

Total operating expenses increased by HK\$6,264m, or 8%, mainly in IT-related costs and professional and consultancy expenses to support business growth, and continued investment in regulatory and compliance programmes, coupled with higher staff costs mainly due to higher performance-related pay.

Share of profit in associates and joint ventures decreased by HK\$232m, or 2%, mainly from the impact of foreign exchange translation.

mix due to growth in customer lending. These increases were partly offset by an increase in financial liabilities to meet the 'Total Loss Absorbing Capacity' requirement, coupled with compressed lending spreads.

At **Hang Seng Bank**, the net interest margin increased by 12 basis points, mainly from improved customer deposit spreads and higher re-investment yields on financial investments following interest rate increases and a change in asset portfolio mix due to growth in customer lending, partly offset by compressed lending spreads.

In mainland China, the net interest margin increased, driven by higher yield from portfolio mix changes due to growth in customer lending, higher re-investment yields from financial investments, coupled with lower cost of funds which benefited from increases in savings and current account deposits, partly offset by reduced lending spreads. In Australia, the net interest margin increased mainly from lower cost of funds following successive interest rate cuts by the Reserve Bank of Australia in 2016, while yield decreased to a lesser extent due to a change in asset portfolio mix as customer lending grew.

Insurance income

(Unaudited)

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

	2017 HK\$m	2016 HK\$m
Net interest income	12,580	11,543
Net fee income	2,800	2,044
Net trading loss	(11)	(1,126)
Net income from financial instruments designated at fair value	15,486	3,315
Net insurance premium income	56,176	55,912
Movement in PVIF	305	7,306
Other operating income	475	771
Total operating income	87,811	79,765
Net insurance claims and benefits paid and movement in liabilities to policyholders	(68,790)	(64,586)
Net operating income	19,021	15,179

Net operating income from the insurance business increased by HK\$3,842m, or 25%, driven by favourable market conditions in 2017.

Net interest income increased by 9% from growth in insurance fund size, reflecting net inflows from new and renewal of life insurance premiums.

Net trading loss decreased mainly due to favourable revaluation of foreign currency swaps in Hong Kong against revaluation losses reported last year.

Net income from financial instruments designated at fair value increased significantly, driven by revaluation gains on the equity portfolio supporting insurance contracts, reflecting strong equity market performance in Hong Kong. To the extent that these gains are attributable to policyholders, there is an offsetting movement reported under 'Net insurance claims and benefits paid and movement in liabilities to policyholders'.

Net insurance premium income increased slightly, as the increase in Hong Kong from new business sales and higher renewals was partly offset by a new reinsurance agreement, coupled with lower insurance premium income in Singapore due to lower new business sales.

The lower favourable movements in the present value of in-force business ('PVIF') was driven by Hong Kong and Singapore. The PVIF movement in Hong Kong was due to the less favourable interest rate assumption update, and also reflected future sharing of higher investment returns with policyholders. The PVIF movement in Singapore was due to changes in actuarial assumptions reflecting regulatory driven changes, and the impact from lapse rate experience and market interest rate movements. These were partly offset by a corresponding movement in 'Net insurance claims and benefits paid and movement in liabilities to policyholders'.

Balance sheet

(Unaudited)

The consolidated balance sheet at 31 December 2017 is set out in the Financial Statements.

Gross loans and advances to customers grew by HK\$495bn, or 17%, to HK\$3,342bn. Gross loans and advances in Hong Kong increased by HK\$314bn, or 18%, largely from increases in corporate and commercial lending, coupled with growth in residential mortgages and other personal lending. Gross loans and advances to customers also increased in mainland China, Australia, Singapore, Malaysia, Taiwan and India.

Overall credit quality remained strong, with total gross impaired loans and advances as a percentage of gross loans and advances standing at 0.53% at the end of 2017, compared with 0.68% at the end of December 2016. Loan impairment charges as a percentage of average gross customer advances remained low at 0.14% for 2017 (2016: 0.20%).

Interest in associates and joint ventures

At 31 December 2017, an impairment review on the group's investment in Bank of Communications Co., Ltd ('BoCom') was carried out and it was concluded that the investment was not impaired based on our value in use calculation (see note 15 on the Financial Statements for further details). In future periods, the value in use may increase or decrease depending on the effect of changes to model inputs. It is expected that the carrying amount will increase in 2018 due to retained earnings earned by BoCom. At the point where the carrying amount exceeds the value in use, the group will determine whether an impairment exists. If so, the group would continue to recognise its share of BoCom's profit or loss, but the carrying amount would be reduced to equal the value in use, with a corresponding reduction in income, unless the market value has increased to a level above the carrying amount.

Customer deposits rose by HK\$238bn, or 5%, to HK\$5,138bn. At 31 December 2017, the advances-to-deposits ratio was 64.8%, compared with 57.8% at 31 December 2016.

Shareholders' equity grew by HK\$68bn to HK\$696bn at 31 December 2017, mainly reflecting current year's profit, net of dividend payment, coupled with an increase in foreign exchange reserve due to appreciation of various currencies against the Hong Kong dollar.

Risk Management

(Unaudited)

All the group’s activities involve to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks. As a provider of banking and financial services, we actively manage risk as a core part of our day-to-day activities.

This section describes the enterprise-wide risk management framework, and the significant policies and practices employed by HSBC in managing its material risks.

Risk management framework

The HSBC Group Head Office formulates high-level risk management policies for the HSBC Group worldwide. We use an

enterprise-wide risk management framework at all levels of the organisation and across all risk types. It is underpinned by a strong risk culture and is reinforced by HSBC Values and our Global Standards.

The framework fosters continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions. It also ensures a consistent approach to monitoring, managing and mitigating the risks we accept and incur in our activities.

The following diagram and descriptions summarise key aspects of the framework: the governance and structure; the risk management tools; and our risk culture, which together help align employee behaviour with our risk appetite.

Key aspects of risk management framework

Key components of our risk management framework

HSBC Values and risk culture		
Risk governance	Non-executive risk governance	The Board approves risk appetite, plans and performance targets which sets the ‘tone from the top’ and is advised by the Group Risk Committee.
	Executive risk governance	Responsible for the enterprise-wide management of all risks, including key policies and frameworks for the management of risk within the group.
Roles and responsibilities	Three lines of defence model	Our ‘Three lines of defence’ model defines roles and responsibilities for risk management. An Independent Risk function ensures the necessary balance in risk/return decisions.
Processes and tools	Risk appetite	Processes to identify, monitor and mitigate risks to ensure we remain within our risk appetite.
	Enterprise-wide risk management tools	
	Active risk management: identification/assessment, monitoring, management and reporting	
Internal controls	Policies and procedures	Policies and procedures define the minimum requirements for the controls required to manage our risks
	Control activities	The operational risk management framework defines minimum standards and processes for managing operational risks and internal controls.
	Systems and infrastructure	Systems and/or processes that support the identification, capture and exchange of information to support risk management activities.
Systems and tools		

Our risk culture

Risk culture refers to HSBC’s norms, attitudes and behaviours related to risk awareness, risk taking and risk management.

HSBC has long recognised the importance of a strong risk culture, the fostering of which is a key responsibility of senior executives. Our risk culture is reinforced by HSBC Values and our Global Standards. It is instrumental in aligning the behaviours of individuals with our attitude to assuming and managing risk, which helps to ensure that our risk profile remains in line with our risk appetite.

We use clear and consistent employee communications on risk to convey strategic messages and set the tone from senior management. A suite of mandatory training on risk and compliance topics is deployed to embed skills and understanding

in order to strengthen our risk culture and reinforce the attitude to risk in the behaviour expected of employees, as described in our risk policies.

Mandatory training materials are updated regularly, describing technical, cultural and ethical aspects of the various risks assumed by the group and how they should be managed effectively. Staff are supported in their roles by a disclosure line which enables them to report matters of concern confidentially.

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

Risk governance structure

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

Executive accountability for the ongoing monitoring, assessment and management of risk resides with the group's Chief Risk Officer, supported by the Risk Management Meeting ('RMM').

The management of financial crime risk resides with the group's Chief Executive Officer. He is supported by the Financial Crime Risk Management Committee.

Day-to-day responsibility for risk management is delegated to senior managers with individual accountability for decision making. All employees have a role to play in risk management. These roles are defined using the three lines of defence model, which takes into account the Group's business and functional structures.

Responsibilities

All employees are required to identify, assess and manage risk within the scope of their responsibilities as part of the three lines of defence model.

Three lines of defence

To create a robust control environment to manage risks, we use an activity-based three lines of defence model. This model delineates management accountabilities and responsibilities for risk management and the control environment.

The model underpins our approach to risk management by clarifying responsibilities, encouraging collaboration and enabling efficient coordination of risk and control activities.

The three lines of defence are summarised below:

- The first line of defence owns the risks and is responsible for identifying, recording, reporting and managing them and ensuring that the right controls and assessments are in place to mitigate these risks.
- The second line of defence sets the policy and guidelines for managing the risks, provides advice and guidance in relation to the risk, and challenges the first line of defence on effective risk management.
- The third line of defence is Internal Audit, which provides independent and objective assurance of the adequacy of the design and operational effectiveness of the Group's risk management framework and control governance process.

Independent Risk function

- The group's Risk function, headed by the group's Chief Risk Officer, is responsible for enterprise-wide risk oversight. This includes establishing and monitoring of risk profiles and forward-looking risk identification and management. The group's Risk function is made up of sub-functions covering all risks to our operations and forms part of the second line of defence. It is independent from the global businesses, including sales and trading functions, to provide challenge, appropriate oversight and balance in risk/return decisions.

Enterprise-wide risk management tools

The Group uses a range of tools to identify, monitor and manage risk. The key enterprise-wide risk management tools are summarised below.

Risk appetite

Our risk appetite encapsulates consideration of financial and non-financial risks and is expressed in both quantitative and qualitative terms. It is applied at the global business level, at the country level, and to material operating entities.

The group's risk appetite defines its desired forward-looking risk profile and informs the strategic and financial planning process. It is also integrated within other risk management tools such as

stress testing and our top and emerging risks report to ensure consistency in risk management practices.

The group sets out the aggregated level and risk types it accepts in order to achieve its business objectives in a Risk Appetite Statement ('RAS'). This is reviewed on an ongoing basis, with formal approval from the Board every six months on the recommendation of the group's Risk Committee.

The group's actual performance is reported monthly against the approved RAS to the RMM, enabling senior management to monitor the risk profile and guide business activities to balance risk and return. This allows risks to be promptly identified and mitigated, and inform risk-adjusted remuneration to drive a strong risk culture across the group.

Global businesses and strategic countries are required to have their own RASs, which are subject to assurance to ensure they remain directionally aligned to the group's RAS. All RASs and business activities are guided and underpinned by a set of qualitative principles. Additionally, quantitative metrics are defined along with appetite and tolerance thresholds for key risk areas.

Risk map

The group risk map provides a point-in-time view of its risk profile across a suite of risk categories. It assess the potential for these risks to materially impact the group's financial results, reputation or business sustainability. Risk stewards assign 'current' and 'projected' risk ratings, supported by commentary. Risks that have an 'Amber' or 'Red' risk rating require monitoring and mitigating action plans to be either in place or initiated to manage the risk down to acceptable levels.

Top and emerging risks

We use a top and emerging risks process to provide a forward-looking view of issues that have the potential to threaten the execution of our strategy or operations over the medium to long term.

We proactively assess the internal and external risk environment, as well as review the themes identified across our regions and global businesses, for any risks that may require global escalation, updating our top and emerging risks as necessary.

We define a 'top risk' as a thematic issue that may form and crystallise between six months and one year, and has the potential to materially affect the group's financial results, reputation or business model. It may arise across any combination of risk types, countries or global businesses. The impact may be well understood by senior management and some mitigating actions may already be in place. Stress tests of varying granularity may already have been carried out to assess the impact.

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

Our top and emerging risks are discussed on page 16.

Stress testing

HSBC operates a comprehensive stress testing programme that supports our risk management and capital planning. It includes execution of stress tests mandated by our regulators, as well as internal stress tests and reverse stress tests. Our stress testing is carried out within a robust governance framework, supported by dedicated teams and is overseen at the most senior level of the group.

Our stress testing programme assesses our capital strength through a rigorous examination of our resilience to external shocks. It also helps us understand and mitigate risks and informs our decisions about capital levels.

Internal stress tests are an important element in our risk management and capital management frameworks. Our capital

Risk

plan is assessed through a range of stress scenarios which explore risks identified by management. They include potential adverse macroeconomic, geopolitical and operational risk events, and other potential events that are specific to the group. The selection of scenarios reflects our top and emerging risks identification process and our risk appetite. Stress testing analysis helps management understand the nature and extent of vulnerabilities to which the bank is exposed. Using this information, management decides whether risks can or should be mitigated through management actions or, if they were to crystallise, should be

Risks managed by HSBC

The material risk types associated with our banking and insurance manufacturing operations are described in the tables below.

Description of risks – banking operations

(Audited)

Risks	Arising from	Measurement, monitoring and management of risk
Credit risk		
The risk of financial loss if a customer or counterparty fails to meet an obligation under a contract.	<ul style="list-style-type: none"> Credit risk arises principally from direct lending, trade finance and leasing business, but also from certain other products such as guarantees and derivatives. 	<p>Credit risk:</p> <ul style="list-style-type: none"> is measured as the amount which could be lost if a customer or counterparty fails to make repayments; is monitored using various internal risk management measures and within limits approved by individuals within a framework of delegated authorities; and is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.
Liquidity and funding risk		
Liquidity risk is the risk that we do not have sufficient financial resources to meet our obligations as they fall due or that we can only do so at an excessive cost. Funding risk is the risk that funding considered to be sustainable, and therefore used to fund assets, is not sustainable over time.	<ul style="list-style-type: none"> Liquidity risk arises from mismatches in the timing of cash flows. Funding risk arises when illiquid asset positions cannot be funded at the expected terms and when required. 	<p>Liquidity and funding risk:</p> <ul style="list-style-type: none"> is measured using a range of metrics including liquidity coverage ratio and net stable funding ratio; is monitored against the Group's liquidity and funding risk framework; and is managed on a stand-alone basis with no reliance on any Group entity (unless pre-committed) or central bank unless this represents routine established business-as-usual market practice.
Market risk		
The risk that movements in market factors, such as foreign exchange rates, interest rates, credit spreads, equity prices and commodity prices, will reduce our income or the value of our portfolios.	<p>Exposure to market risk is separated into two portfolios:</p> <ul style="list-style-type: none"> Trading portfolios Non-trading portfolios 	<p>Market risk:</p> <ul style="list-style-type: none"> is measured in terms of value at risk ('VaR'), which measures the potential losses on risk positions over a specified time horizon for a given level of confidence, and assessed using stress testing; is monitored using VaR, stress testing and other measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange; and is managed using risk limits approved by the RMM for the group and the various global businesses.
Operational risk		
The risk that achieving our strategy or objectives as a result of inadequate or failed internal processes, people and systems or from external events.	<ul style="list-style-type: none"> Operational risk arises from day-to-day operations or external events, and is relevant to every aspect of our business. Regulatory compliance risk and financial crime risk are discussed below. 	<p>Operational risk:</p> <ul style="list-style-type: none"> is measured using the risk and control assessment process, which assesses the level of risk and effectiveness of controls; is monitored using key indicators and other internal control activities; and is primarily managed by global business and functional managers who identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls using the operational risk management framework.
Regulatory compliance risk		
The risk that we fail to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice, and incur fines and penalties and suffer damage to our business as a consequence.	<ul style="list-style-type: none"> Regulatory compliance risk is part of operational risk, and arises from the risks associated with breaching our duty to clients and other counterparties, inappropriate market conduct and breaching other regulatory requirements. 	<p>Regulatory compliance risk:</p> <ul style="list-style-type: none"> is measured by reference to identified metrics, incident assessments, regulatory feedback and the judgement and assessment of our regulatory compliance teams; is monitored against the first line of defence risk and control assessments, the results of the monitoring and control assurance activities of the second line of defence functions, and the results of internal and external audits and regulatory inspections; and is primarily managed by establishing and communicating appropriate policies and procedures, training employees in them, and monitoring activity to help ensure their observance. Proactive risk control and/or remediation work is undertaken where required.

absorbed through capital. This in turn informs decisions about preferred capital levels.

Reverse stress tests are conducted annually at Group and, where required, subsidiary entity level in order to understand which potential extreme conditions would make our business model non-viable. Reverse stress testing identifies potential stresses and vulnerabilities which the group might face, and helps inform early-warning triggers, management actions and contingency plans designed to mitigate risks.

Description of risks – banking operations

(Audited)

Risks	Arising from	Measurement, monitoring and management of risk
Financial crime risk		
The risk that we knowingly or unknowingly help parties to commit or to further potentially illegal activity through HSBC.	<ul style="list-style-type: none"> Financial crime risk is part of operational risk and arises from day-to-day banking operations. 	<p>Financial crime risk:</p> <ul style="list-style-type: none"> is measured by reference to identified metrics, incident assessments, regulatory feedback and the judgement and assessment of our Financial Crime Risk teams; is monitored against our financial crime risk appetite statements and metrics, the results of the monitoring and control activities of the second line of defence functions, and the results of internal and external audits and regulatory inspections; and is managed by establishing and communicating appropriate policies and procedures, training employees in them, and monitoring activity to assure their observance. Proactive risk control and/or remediation work is undertaken where required.
Other material risks		
Reputational risk		
The risk of failure to meet stakeholders' expectations as a result of any event, behaviour, action or inaction, either by HSBC itself, our employees or those with whom we are associated, that might cause stakeholders to form a negative view of the Group.	<ul style="list-style-type: none"> Primary reputational risks arise directly from an action or inaction by HSBC, its employees or associated parties that are not the consequence of another type of risk. Secondary reputational risks are those arising indirectly and are a result of a failure to control any other risks. 	<p>Reputational risk:</p> <ul style="list-style-type: none"> is measured by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees; is monitored through a reputational risk management framework that is integrated into the Group's broader risk management framework; and is managed by every member of staff and is covered by a number of policies and guidelines. There is a clear structure of committees and individuals charged with mitigating reputational risk.
Pension risk		
The risk that the performance of assets held in pension plans is insufficient to cover existing pension liabilities resulting in an increase in obligation to support the plans.	<ul style="list-style-type: none"> Pension risk arises from investments delivering an inadequate return, adverse changes in interest rates or inflation, or members living longer than expected. Pension risk includes operational risks listed above. 	<p>Pension risk:</p> <ul style="list-style-type: none"> is measured in terms of the schemes' ability to generate sufficient funds to meet the cost of their accrued benefits; is monitored through the specific risk appetite; and is managed through the appropriate pension risk governance structure.
Sustainability risk		
The risk that financial services provided to customers by the group indirectly result in unacceptable impacts on people or on the environment.	<ul style="list-style-type: none"> Sustainability risk arises from the provision of financial services to companies or projects which indirectly result in unacceptable impacts on people or on the environment. 	<p>Sustainability risk:</p> <ul style="list-style-type: none"> is measured assessing the potential sustainability effect of a customer's activities and assigning a Sustainability Risk Rating to all high risk transactions; is monitored by the RMM and by Group Sustainability Risk; and is managed using sustainability risk policies covering project finance lending and sector-based sustainability policies for sectors and themes with potentially high environmental or social impacts.

Our insurance manufacturing subsidiaries are separately regulated from our banking operations. Risks in the insurance entities are managed using methodologies and processes appropriate to insurance manufacturing operations, but remain subject to

oversight at group level. Our insurance operations are also subject to some of the same risks as our banking operations, which are covered by the group's respective risk management processes.

Risk

Description of risks – insurance manufacturing operations

Risks	Arising from	Measurement, monitoring and management of risk
Insurance risks		
The risk that, over time, the cost of acquiring and administering an insurance contract and paying claims and benefits may exceed the total amount of premiums and investment income received.	<ul style="list-style-type: none"> The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, as well as lapse and surrender rates. 	Insurance risk: <ul style="list-style-type: none"> is measured in terms of life insurance liabilities and economic capital allocated to insurance underwriting risk; is monitored through a framework of approved limits and delegated authorities; and is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance. This includes using product design, underwriting, reinsurance and claims-handling procedures.
Financial risks		
Our ability to effectively match the liabilities arising under insurance contracts with the asset portfolios that back them is contingent on the management of financial risks and the extent to which these risks are borne by the policyholders.	Exposure to financial risks arises from: <ul style="list-style-type: none"> market risk of changes in the fair values of financial assets or their future cash flows; credit risk; and liquidity risk of entities being unable to make payments to policyholders as they fall due. 	Financial risks: <ul style="list-style-type: none"> are measured separately for each type of risk: <ul style="list-style-type: none"> market risks are measured in terms of exposure to fluctuations in key financial variables; credit risk is measured as the amount which could be lost if a counterparty fails to make repayments; and liquidity risk is measured using internal metrics including stressed operational cash flow projections; are monitored within a framework of approved limits and delegated authorities; and are managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance. This includes using product design, asset liability matching and bonus rates.

Top and emerging risks

(Unaudited)

Our approach to identifying and monitoring top and emerging risks is described on page 13. Our current key top and emerging risks are as follows:

- Deferred Prosecution Agreement and related agreements and consent orders
- Adverse credit risk outlook
- Cyber threat and unauthorised access to systems
- Elevated regional political risk
- Financial crime risk environment
- Regulatory developments with adverse impact on business model and profitability
- Impact of organisational change and regulatory demand on employees

Deferred Prosecution Agreement and related agreements and consent orders

HSBC was subject to a deferred prosecution agreement ('US DPA'). The US DPA and the work of the independent compliance monitor ('the Monitor') are discussed on page 29.

In December 2017, the US DPA agreement expired as HSBC lived up to all of its commitments. The US Department of Justice ('DoJ') conveyed its expectation prior to the DPA's expiration that HSBC would follow through on certain requests that had been made by the DoJ. The risk of enforcement in the US remains high due to a number of factors, including that Monitor's reports will continue to be provided to the DoJ through to the end of July 2018. The role of the Monitor will continue under the appointment of the UK FCA.

Financial crime risks that may arise from clearing payments on behalf of HSBC affiliates, particularly US dollar transactions, has heightened. If clearing banks fail to conduct adequate due diligence on clients, including affiliates, or the affiliates do not remediate with urgency any control deficiencies in this regard, it could result in the curtailment of currency clearing services for certain Group affiliates.

Mitigating actions

- We are working to ensure that the reforms we have put in place are both effective and sustainable over the longterm. Work in this area will continue to be consistent with the strategic

objective of implementing the most effective standards to combat financial crime across our operations globally.

Adverse credit risk outlook

Following the 19th National Congress in October 2017, the Chinese Government increased its effort in reigning in shadow banking, aggressive overseas acquisitions, reforming the financial markets including capital flow and renminbi volatility. Private sector corporates ('POEs') that are highly leveraged and / or with weak corporate governance are likely to be particularly vulnerable in this trend of increased regulatory scrutiny and tightening liquidity.

Trade relations among major economies including the US, mainland China, European Union, Japan, etc., remain fluid, with occasional rhetoric by national leaders that pose the threat of trade disruptions. The fact that trade policies are often used as tactics in wider geopolitical negotiations brings further uncertainty.

Mitigating actions

- We continue to focus on strengthening client selection and early risk identification, while staying close to future regulations that are currently in draft stage.
- We stress test those portfolios of particular concern to identify sensitivity to loss, with management actions taken to control appetite where necessary.
- Reviews of key portfolios are undertaken regularly to ensure that individual customer or portfolio risks are understood, and that the level of facilities offered and our ability to manage through any downturn are appropriate.

Cyber threat and unauthorised access to systems

The group and other public and private organisations continue to be the targets of increasingly sophisticated cyber attacks. Ransomware and distributed denial of service attacks appear to be an increasingly dominant threat to the financial industry, which may result in disruption to our operations and customer-facing websites or loss of customer data.

Mitigating actions

- We continue to strengthen and invest significantly in our ability to prevent, detect and respond to the ever-increasing and sophisticated threat of cyber-attacks. Specifically, we continue to enhance our capabilities to protect against increasingly sophisticated malware, denial of service attacks and data

leakage prevention as well as enhancing our security event detection and incident response processes.

- We participate in intelligence sharing with both law enforcement and industry schemes to help improve our understanding of, and ability to respond to, the evolving threats faced by ourselves and our peers within our industry.

Elevated regional political risk

Tensions continue to rise between North Korea and the US as a result of North Korean progress in its missile and nuclear programmes. The stronger Chinese enforcement of UN sanctions on North Korea may not halt further missile and nuclear tests. Any escalation could have a significant impact on regional and global trade.

Mitigating actions

- We continuously monitor the geopolitical outlook, in particular in countries where we have material exposures and/or a physical presence.
- We use internal stress tests and scenario analysis as well as regulatory stress test programmes, to adjust limits and exposures to reflect our risk appetite and mitigate risks as appropriate. Our internal credit risk ratings of sovereign counterparties take into account geopolitical developments that could potentially disrupt our portfolios and businesses.

Financial crime risk environment

Financial institutions remain under considerable regulatory scrutiny regarding their ability to prevent and detect financial crime. Financial crime threats continue to evolve, often in tandem with geopolitical developments. The financial crime risks related to the use of innovative financial technology are not yet fully understood, while the changing sanctions regulatory landscape presents execution challenges.

Mitigating actions

- We continued to enhance our Financial Crime Risk function.
- We strengthened governance processes during 2017 by establishing formal financial crime risk governance committees at global business and country levels of the organisation. This will help to ensure appropriate oversight and escalation of issues to the Financial Crime Risk Management Committee of the group.
- We are working to develop enhanced risk management capabilities through better use of sophisticated analytical techniques.

Regulatory developments with adverse impact on business model and profitability

Financial service providers continue to face stringent regulatory and supervisory requirements, particularly in the areas of capital and liquidity management, conduct of business, financial crime, internal control frameworks, the use of models and the integrity of financial services delivery. The competitive landscape in which the group operates may be significantly altered by future regulatory changes and government intervention.

Mitigating actions

- We are fully engaged with governments and regulators in the countries in which we operate to help ensure that new requirements are considered properly by regulatory authorities and the financial sector and can be implemented effectively.

Impact of organisational change and regulatory demand on employees

Our success in delivering the group's strategic priorities, as well as significant regulatory change programmes, depends in part on the retention of key members of our management team and wider employee base. The ability to continue to attract, train, motivate and retain highly qualified professionals in an employment market where expertise is often in short supply and mobile is critical, and may depend on factors beyond our control, including economic, market and regulatory conditions.

Mitigating actions

- Through dedicated work streams, we continue to develop succession plans using a broad array of talent-sourcing channels for key management roles, which are reviewed on a regular basis.
- Risks related to organisational change are subject to close management oversight. A range of actions are being developed to address the risks associated with the group's major change initiatives.

Credit Risk

(Audited)

Credit risk generates the largest regulatory capital requirement of the risks we incur. The group has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities. The group's principal credit risk management procedures and policies, which follow policies established by HSBC Group Head Office, include the following:

- Formulating credit policies which are consistent with the Group credit policy and documenting these in detail in dedicated manuals.
- Establishing and maintaining the group's large credit exposure policy. This policy delineates the group's maximum exposures to individual customers, customer groups and other risk concentrations.
- Establishing and complying with lending guidelines on the group's attitude towards, and appetite for, lending to specified market sectors and industries.
- Undertaking an objective assessment of risk. All commercial non-bank credit facilities originated by the group in excess of designated limits are subject to review prior to the facilities being committed to customers.
- Controlling exposures to banks and other financial institutions. The group's credit and settlement risk limits to counterparties in the finance and government sectors are designed to optimise the use of credit availability and avoid excessive risk concentration.
- Managing exposures to debt securities by establishing controls in respect of the liquidity of securities held for trading and setting issuer limits for financial investments. Separate portfolio limits are established for asset-backed securities and similar instruments.
- Controlling cross-border exposures to manage country and cross-border risk through the imposition of country limits, with sub-limits by maturity and type of business.
- Controlling exposures to selected industries. When necessary, restrictions are imposed on new business, or exposures in the group's operating entities are capped.
- Maintaining and developing risk ratings in order to categorise exposures meaningfully and facilitate focused management of the attendant risks. Rating methodology is based upon a wide range of financial analytics together with market data-based tools which are core inputs to the assessment of counterparty risk. Although automated risk-rating processes are increasingly used for the larger facilities, ultimate responsibility for setting risk grades rests in each case with the final approving executive. Risk grades are reviewed frequently and amendments, where necessary, are implemented promptly.

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

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

Risk

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

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

(i) Credit exposure

Maximum exposure to credit risk

(Audited)

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

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements (unless such credit enhancements meet accounting offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

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

	2017 HK\$m	2016 HK\$m
Cash and sight balances at central banks	208,073	213,783
Items in the course of collection from other banks	25,714	21,401
Hong Kong Government certificates of indebtedness	267,174	242,194
Trading assets	389,133	299,719
Derivatives	300,243	479,807
Financial assets designated at fair value	18,656	17,853
Reverse repurchase agreements – non-trading	330,890	271,567
Placings with and advances to banks	433,005	463,211
Loans and advances to customers	3,328,980	2,834,114
Financial investments	1,711,598	1,826,640
Amounts due from Group companies	227,729	242,773
Other assets	93,610	84,162
Financial guarantees and other credit-related contingent liabilities	57,353	64,017
Loan and other credit-related commitments	2,779,845	2,655,816
At 31 Dec	10,172,003	9,717,057

Total exposure to credit risk remained broadly unchanged in 2017 with loans and advances continuing to be the largest element.

(ii) Credit quality of financial instruments

(Audited)

Five broad classifications describe the credit quality of the group's lending and debt securities portfolios. Each of these classifications encompasses a range of more granular, internal credit rating grades assigned to wholesale and retail lending businesses, as well as ratings attributed by external agencies to debt securities.

For debt securities and certain other financial instruments, external ratings have been aligned to five credit quality classifications based on the mapping of related customer risk ratings ('CRR') to external credit ratings. The mapping is reviewed on a regular basis.

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

Credit quality classification	Sovereign debt securities and bills	Other debt securities and bills	Wholesale lending and derivatives		Retail lending	
	External credit rating	External credit rating	Internal credit rating	12 month probability of default %	Internal credit rating ¹	Expected loss %
Strong	BBB and above	A- and above	CRR1 to CRR2	0 - 0.169	EL ² 1 to EL2	0 - 0.999
Good	BBB- to BB	BBB+ to BBB-	CRR3	0.170 - 0.740	EL3	1.000 - 4.999
Satisfactory	BB- to B, and unrated	BB+ to B, and unrated	CRR4 to CRR5	0.741 - 4.914	EL4 to EL5	5.000 - 19.999
Sub-standard	B- to C	B- to C	CRR6 to CRR8	4.915 - 99.999	EL6 to EL8	20.000 - 99.999
Impaired	Default	Default	CRR9 to CRR10	100	EL9 to EL10	100+ or defaulted ³

¹ We observe the disclosure convention that, in addition to those classified as EL9 to EL10, retail accounts classified EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired (see page 21, 'Ageing analysis of past due but not impaired financial instruments').

² Expected loss.

³ The EL percentage is derived through a combination of PD and LGD, and may exceed 100% in circumstances where the LGD is above 100%, reflecting the cost of recoveries. Please refer to note 36 for definitions of PD and LGD.

Credit quality classification definitions

(Audited)

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

considered impaired. Such accounts may occur in any retail EL grade, whereby in the higher credit quality grades, the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

Granular risk rating scales

(Audited)

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

The EL 10-grade scale for retail business summarises a more granular underlying EL scale for these customer segments; this combines obligor and facility/product risk factors in a composite measure. The external ratings cited above have, for clarity of reporting, been assigned to the credit quality classifications defined for internally-rated exposures.

The basis of reporting reflects risk rating systems under the HSBC Group's Basel II programme and extends the range of financial instruments covered in the presentation of portfolio credit quality.

Impairment is not measured for financial instruments held in trading portfolios or designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the income statement.

Risk

Distribution of financial instruments by credit quality

(Audited)

	Neither past due nor impaired				Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Good HK\$m	Satisfactory HK\$m	Sub-standard HK\$m				
At 31 Dec 2017								
Items in the course of collection from other banks	24,420	219	1,075	–	–	–	–	25,714
Trading assets	324,060	27,258	37,216	599	–	–	–	389,133
Derivatives	253,480	38,202	7,855	706	–	–	–	300,243
Financial assets designated at fair value	17,032	855	767	2	–	–	–	18,656
Reverse repurchase agreements – non-trading	249,043	50,103	31,744	–	–	–	–	330,890
Placings with and advances to banks held at amortised cost	401,097	28,366	3,433	109	–	–	–	433,005
Loans and advances to customers held at amortised cost	1,772,405	805,145	696,882	20,136	29,878	17,579	(13,045)	3,328,980
– personal	992,682	101,938	56,398	641	18,930	4,686	(2,106)	1,173,169
– corporate and commercial	666,138	649,775	604,638	19,139	8,742	12,695	(10,728)	1,950,399
– non-bank financial institutions	113,585	53,432	35,846	356	2,206	198	(211)	205,412
Financial investments	1,628,709	40,980	41,909	–	–	–	–	1,711,598
Other assets	40,817	19,582	31,945	593	486	187	–	93,610
Total	4,711,063	1,010,710	852,826	22,145	30,364	17,766	(13,045)	6,631,829
At 31 Dec 2016								
Items in the course of collection from other banks	19,557	103	1,740	1	–	–	–	21,401
Trading assets	248,523	23,449	27,348	399	–	–	–	299,719
Derivatives	404,360	62,446	11,923	1,078	–	–	–	479,807
Financial assets designated at fair value	16,741	463	649	–	–	–	–	17,853
Reverse repurchase agreements – non-trading	204,144	49,580	17,835	8	–	–	–	271,567
Placings with and advances to banks held at amortised cost	427,060	31,786	4,031	334	–	–	–	463,211
Loans and advances to customers held at amortised cost	1,406,265	741,754	624,632	28,304	26,473	19,378	(12,692)	2,834,114
– personal	894,151	80,243	46,548	1,120	18,230	4,388	(2,198)	1,042,482
– corporate and commercial	441,340	608,415	551,446	26,923	7,864	14,777	(10,419)	1,640,346
– non-bank financial institutions	70,774	53,096	26,638	261	379	213	(75)	151,286
Financial investments	1,716,823	71,072	38,745	–	–	–	–	1,826,640
Other assets	33,048	17,873	30,598	2,105	382	156	–	84,162
Total	4,476,521	998,526	757,501	32,229	26,855	19,534	(12,692)	6,298,474

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

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

(Audited)

The amounts in the following table reflect exposures designated as past due but not impaired. Examples of exposures designated as

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

Ageing analysis of past due but not impaired financial instruments

	Up to 29 days HK\$m	30-59 days HK\$m	60-89 days HK\$m	90-180 days HK\$m	Over 180 days HK\$m	Total HK\$m
At 31 Dec 2017						
Loans and advances to customers held at amortised cost ¹	24,976	3,572	1,326	4	–	29,878
– personal	15,272	2,704	954	–	–	18,930
– corporate and commercial	7,498	868	372	4	–	8,742
– non-bank financial institutions	2,206	–	–	–	–	2,206
Other assets	98	35	54	59	240	486
	25,074	3,607	1,380	63	240	30,364
At 31 Dec 2016						
Loans and advances to customers held at amortised cost ¹	21,182	3,865	1,421	5	–	26,473
– personal	14,402	2,818	1,010	–	–	18,230
– corporate and commercial	6,499	949	411	5	–	7,864
– non-bank financial institutions	281	98	–	–	–	379
Other assets	206	42	28	51	55	382
	21,388	3,907	1,449	56	55	26,855

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

(iv) Impaired loans and advances

(Audited)

The group's policy for recognising and measuring impairment allowances on both individually assessed loans and advances and those which are collectively assessed on a portfolio basis is described in note 1.2(d) on the Financial Statements.

Analyses of impairment allowances at 31 December 2017, and the movement of such allowances during the year, are disclosed in note 11 on the Financial Statements.

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

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

(v) Impairment assessment

(Audited)

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

For details of our impairment policies on loans and advances and financial investments, see notes 1.2(d) and 1.2(e) on the Financial Statements.

Impairment and credit risk mitigation

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

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

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

Risk

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

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

Personal lending

(Audited)

Residential mortgages including loan commitments by level of collateral

	2017 HK\$m	2016 HK\$m
Unimpaired loans		
Fully collateralised	905,997	807,534
Partially collateralised		
– greater than 100% LTV (A)	420	320
– collateral value on A	378	206
Not collateralised	44	15
At 31 Dec	906,461	807,869
Impaired loans		
Fully collateralised	2,223	1,913
– less than 70% LTV	1,635	1,410
– 71% to 90% LTV	498	372
– 91% to 100% LTV	90	131
Partially collateralised		
– greater than 100% LTV (B)	80	51
– collateral value on B	69	42
Not collateralised	1	1
At 31 Dec	2,304	1,965
	908,765	809,834

The above table shows residential mortgage lending including off-balance sheet loan commitments, by level of collateral. The collateral included in the table above consists of fixed first charges on real estate.

The LTV ratio is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The methodologies for obtaining residential property collateral values vary throughout the group, but are typically determined through a combination of professional appraisals, house price indices or statistical analysis. Valuations are updated on a regular basis and,

(vi) Collateral and other credit enhancements

(Audited)

Loans and advances

Although collateral can be an important mitigant of credit risk, it is the group's general practice to lend on the basis of the customer's ability to meet their obligations out of their cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured. For other lending, a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default, the bank may use the collateral as a source of repayment.

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

We may also manage our risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised may benefit from such credit mitigants.

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

Other personal lending

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

Corporate, commercial and non-bank financial institutions lending

(Audited)

Collateral held is analysed below separately for commercial real estate and for other corporate, commercial and non-bank financial

institutions lending. This reflects the difference in level of collateral held on the portfolios. In each case, the analysis includes off-balance sheet loan commitments, primarily undrawn credit lines.

Commercial real estate loans and advances including loan commitments by level of collateral

	2017 HK\$m	2016 HK\$m
Rated CRR/EL 1 to 7	392,706	318,874
Not collateralised	143,315	98,601
Fully collateralised	236,710	211,694
Partially collateralised (A)	12,681	8,579
– collateral value on A	7,616	4,283
Rated CRR/EL 8	3	3
Not collateralised	–	–
Fully collateralised	3	2
Partially collateralised (B)	–	1
– collateral value on B	–	1
Rated CRR/EL 9 to 10	128	168
Not collateralised	10	25
Fully collateralised	72	101
Partially collateralised (C)	46	42
– collateral value on C	33	46
At 31 Dec	392,837	319,045

The collateral included in the table above consist of fixed first charges on real estate and charges over cash for the commercial real estate sector. The table includes lending to major property developers which is typically secured by guarantees or is unsecured.

The value of commercial real estate collateral is determined through a combination of professional and internal valuations and physical inspection. Due to the complexity of collateral valuations for commercial real estate, local valuation policies determine the

frequency of review based on local market conditions. Revaluation are sought with greater frequency where, as part of the regular credit assessment of the obligor, material concerns arise in relation to the transaction which may reflect on the underlying performance of the collateral, or in circumstances where an obligor's credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation (i.e. the obligor's credit quality classification indicates it is at the lower end e.g. sub-standard, or approaching impaired).

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

(Audited)

	2017 HK\$m	2016 HK\$m
Rated CRR/EL 8	1,492	3,258
Not collateralised	331	3,139
Fully collateralised	68	24
Partially collateralised (A)	1,093	95
– collateral value on A	97	25
Rated CRR/EL 9 to 10	12,774	15,033
Not collateralised	7,236	6,581
Fully collateralised	2,858	3,472
Partially collateralised (B)	2,680	4,980
– collateral value on B	1,625	2,081
At 31 Dec	14,266	18,291

The collateral used in the assessment of the above primarily includes first legal charges over real estate and charges over cash in the commercial and industrial sector, and charges over cash and marketable financial instruments in the financial sector.

It should be noted that the table above excludes other types of collateral which are commonly taken for corporate and commercial lending such as unsupported guarantees and floating charges over the assets of a customer's business. While such mitigants have value, and often provide rights in insolvency, their assignable value is insufficiently certain. They are assigned no value for disclosure purposes.

As with commercial real estate, the value of real estate collateral included in the table above is generally determined through a combination of professional and internal valuations and physical inspection. The frequency of revaluation is undertaken on a similar basis to commercial real estate loans and advances; however, for lending activities that are not predominantly commercial real

estate-oriented, collateral value is not as strongly correlated to principal repayment performance. Collateral values will generally be refreshed when an obligor's general credit performance deteriorates and it is necessary to assess the likely performance of secondary sources of repayment should reliance upon them prove necessary. For this reason, the table above reports values only for customers with CRR 8 to 10, reflecting that these loans and advances generally have valuations which are comparatively recent. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

Placings with and advances to banks

(Audited)

Placings with and advances to banks are typically unsecured. At 31 December 2017, 2% of the placings with and advances to banks rated CRR/EL 1 to 7, including loan commitments, are fully collateralised (2016: 4%).

Risk

Derivatives

(Audited)

The International Swaps and Derivatives Association ('ISDA') Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over the counter ('OTC') products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or another pre-agreed termination event occurs. It is common, and our preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institution clients. Please refer to note 33 'Offsetting of financial assets and liabilities' for further details.

Other credit risk exposures

(Audited)

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

Government, bank and other financial institution-issued securities may benefit from additional credit enhancement, notably through government guarantees that reference these assets. Corporate-issued debt securities are primarily unsecured. Debt securities issued by banks and financial institutions include asset-backed securities ('ABS') and similar instruments, which are supported by underlying pools of financial assets. Credit risk associated with ABS is reduced through the purchase of credit default swap ('CDS') protection.

The group's maximum exposure to credit risk includes financial guarantees and similar arrangements that it issues or enters into, and loan commitments to which it is irrevocably committed. Depending on the terms of the arrangement, the bank may have recourse to additional credit mitigation in the event that a guarantee is called upon, or a loan commitment is drawn and subsequently defaults. Further information about these arrangements is provided in note 31 'Contingent liabilities and commitments'.

Liquidity and Funding Risk Management

(Audited)

Liquidity and funding risk management framework

HSBC has an internal liquidity and funding risk management framework ('LFRF') which aims to allow it to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations.

The management of liquidity and funding is primarily undertaken locally (by country) in our operating entities in compliance with the Group's LFRF, and with practices and limits set by the Group Management Board ('GMB') through the RMM and approved by the Board. Our general policy is that each defined operating entity should be self-sufficient in funding its own activities.

The Group Treasurer, who reports to the Group CFO, has responsibility for the oversight of the LFRF. Asset, Liability and Capital Management ('ALCM') teams are responsible for the application of the LFRF at a local operating entity level.

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

Operating entities are predominately defined on a country basis to reflect our local management of liquidity and funding. Typically, an operating entity will be defined as a single branch or legal entity.

The Board is ultimately responsible for determining the types and magnitude of liquidity risk that the group is able to take and

ensuring that there is an appropriate organisation structure for managing this risk. Under authorities delegated by the Board, the group ALCO is responsible for managing all ALCM issues including liquidity and funding risk management.

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

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

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

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

The LFRF is delivered using the following key aspects:

- stand-alone management of liquidity and funding by operating entity;
- minimum liquidity coverage ratio ('LCR') requirement for each operating entity;
- minimum net stable funding ratio ('NSFR') requirement for each operating entity;
- legal entity depositor concentration limit;
- three-month and 12-month cumulative rolling term contractual maturity limits covering deposits from banks, deposits from non-bank financial institutions and securities issued;
- annual individual liquidity adequacy assessment ('ILAA') by principal operating entity;
- minimum LCR requirement by currency;
- intraday liquidity;
- liquidity funds transfer pricing; and
- forward-looking funding assessments.

The two key objectives of the ILAA process are to:

- demonstrate that all material liquidity and funding risks are captured within the internal framework; and
- validate the operating entity's risk tolerance/appetite by demonstrating that reverse stress testing scenarios are acceptably remote; and vulnerabilities have been assessed through the use of severe stress scenarios.

Management of liquidity and funding risk

Liquidity coverage ratio

(Unaudited)

The LCR aims to ensure that a bank has sufficient unencumbered high-quality liquid assets ('HQLA') to meet its liquidity needs in a 30-calendar-day liquidity stress scenario. HQLA consist of cash or assets that can be converted into cash at little or no loss of value in markets.

At 31 December 2017, all the group's operating entities were within the LCR risk tolerance level established by the Board and applicable under the LFRF.

Net stable funding ratio

(Unaudited)

The NSFR requires institutions to maintain sufficient stable funding relative to required stable funding, and reflects a bank's long-term funding profile (funding with a term of more than a year). It is designed to complement the LCR.

At 31 December 2017, all the group's operating entities were within the NSFR risk tolerance level established by the Board and applicable under the LFRF.

Depositor concentration and term funding maturity concentration

(Unaudited)

The LCR and NSFR metrics assume a stressed outflow based on a portfolio of depositors within each deposit segment. The validity of these assumptions is challenged if the portfolio of depositors is not large enough to avoid depositor concentration. Operating entities are exposed to term re-financing concentration risk if the current maturity profile results in future maturities being overly concentrated in any defined period.

At 31 December 2017, all the group's operating entities were within the risk tolerance levels set for depositor concentration and

term funding maturity concentration. These risk tolerances were established by the Board and applicable under the LFRF.

Sources of funding

(Audited)

Our primary sources of funding are customer current accounts and customer savings deposits payable on demand or at short notice. We issue wholesale securities (secured and unsecured) to supplement our customer deposits and change the currency mix, maturity profile or location of our liabilities.

Currency mismatch

(Audited)

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

Additional contractual obligations

(Unaudited)

Under the terms of our current collateral obligations under derivative contracts (which are ISDA compliant CSA contracts), the additional collateral required to post in the event of one-notch and two-notch downgrade in credit ratings is immaterial.

Liquidity regulation

(Unaudited)

The Banking (Liquidity) Rules ('BLR') were introduced by the HKMA in 2014 and became effective from 1 January 2015. The group is required to calculate its LCR on a consolidated basis in accordance with rule 11(1) of the BLR. During 2017 the group is required to maintain an LCR of not less than 80%, increasing in steps of 10% each year to not less than 100% by January 2019.

The average LCRs for the period are as follows:

	Quarter ended							
	31 Dec 2017	30 Sep 2017	30 Jun 2017	31 Mar 2017	31 Dec 2016	30 Sept 2016	30 Jun 2016	30 Mar 2016
	%	%	%	%	%	%	%	%
Average LCRs	153.6	158.0	162.1	170.9	184.9	189.6	193.6	186.6

The liquidity position of the group remained strong in 2017. The average LCR decreased by 31.3% from 184.9% for the quarter ended 31 December 2016 to 153.6% for the quarter ended 31 December 2017, mainly as a result of the growth in loans and advances to customers.

The majority of HQLA included in the LCR are Level 1 assets as defined in the BLR, which consist mainly of government debt securities.

The total weighted amount of HQLA for the period are as follows:

	Weighted amount (average value) at quarter ended							
	31 Dec 2017	30 Sep 2017	30 Jun 2017	31 Mar 2017	31 Dec 2016	30 Sept 2016	30 Jun 2016	31 Mar 2016
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Level 1 assets	1,405,999	1,387,825	1,374,550	1,497,076	1,580,397	1,533,814	1,512,512	1,510,252
Level 2A assets	65,248	67,923	60,895	60,761	59,571	64,572	64,381	55,134
Level 2B assets	20,071	18,961	15,064	11,147	10,954	12,250	10,136	7,266
Total	1,491,318	1,474,709	1,450,509	1,568,984	1,650,922	1,610,636	1,587,029	1,572,652

Further details of the group's liquidity information disclosures can be viewed in the Banking Disclosure Statement 2017, which will be available in the Regulatory Disclosure Section of our website: www.hsbc.com.hk.

Risk

Market Risk

(Audited)

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

There were no significant changes to our policies and practices for the management of market risk in 2017.

Exposure to market risk

Exposure to market risk is separated into two portfolios:

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

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

	Trading risk	Non-trading risk
Risk types	<ul style="list-style-type: none"> • Foreign exchange and commodities • Interest rates • Credit spreads • Equities 	<ul style="list-style-type: none"> • Structural foreign exchange • Interest rates • Credit spreads
Global business	GB&M incl BSM	GB&M, BSM, GPB, CMB and RBWM
Risk measure	VaR Sensitivity Stress Testing	VaR Sensitivity Stress Testing

Note—Balance Sheet Management ('BSM'), for external reporting purposes, forms part of Corporate Centre while daily operations and risk are managed within GB&M.

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

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

Market risk governance

(Unaudited)

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

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

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

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

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

Market risk measures

(Audited)

Monitoring and limiting market risk exposures

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

Sensitivity analysis

(Unaudited)

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

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

Value at risk

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

In addition, the group calculates VaR for non-trading portfolios in order to have a complete picture of market risk. Where VaR is not calculated explicitly, alternative tools are used as summarised in the Market Risk stress testing section below.

Our models are predominantly based on historical simulation which incorporate the following features:

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

The models also incorporate the effect of the option features on the underlying exposures. The nature of the VaR models means that an increase in observed market volatility will lead to an increase in VaR without any changes in the underlying positions.

VaR model limitations

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

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a holding period assumes that all positions can be liquidated or the risks offset during that period. This may not fully reflect the market risk arising at times of severe illiquidity, when the holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% 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.

Back-testing

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

We would expect on average to see two to three profits, and two or three losses, in excess of VaR at the 99% confidence level over a one-year period. The actual number of profits or losses in excess of VaR over this period can therefore be used to gauge how well the models are performing. We back-test our group-level VaR which reflects the full legal entity scope of the group, including entities that do not have local permission to use VaR for regulatory purposes.

Risk not in VaR framework

(Unaudited)

The RNIV framework aims to manage and capitalise material market risks that are not adequately covered in the VaR model.

Risk factors are reviewed on a regular basis and either incorporated directly in the VaR models, where possible, or quantified through the VaR-based RNIV approach or a stress test approach within the RNIV framework. The outcome of the VaR-based RNIV is included in the VaR calculation and back-testing; a stressed VaR RNIV is also computed for the risk factors considered in the VaR-based RNIV approach. Stress-type RNIVs include a gap

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

Trading value at risk, 99% 1 day¹

	Foreign exchange and commodity HK\$m	Interest rate HK\$m	Equity HK\$m	Credit spread HK\$m	Portfolio diversification ² HK\$m	Total HK\$m
At 31 Dec 2017						
Year end	48	128	19	69	(123)	141
Average	48	118	13	28		111
Maximum	84	202	25	73		189
At 31 Dec 2016						
Year end	27	95	14	17	(56)	97
Average	52	108	13	23		110
Maximum	78	161	26	54		181

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

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

risk exposure measure to capture risk on non-recourse margin loans and a de-peg risk measure to capture risk to pegged and heavily-managed currencies.

Stress testing

(Audited)

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

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

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

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

Market risk in 2017

(Unaudited)

Asian markets proved resilient to geopolitical/political shocks in 2017 with robust economic growth, low inflation and subdued market risk volatility generating rising asset prices for Asian equities and fixed income markets. The prospect of continued US interest rate hikes could attract capital outflows from emerging markets and increase the cost of the USD funding globally and drain funding liquidity away from the emerging markets. Geopolitical events including the Korea Peninsula and US policy priorities were among the key drivers for market volatility in 2017.

Trading portfolios

(Audited)

Value at risk of the trading portfolios

Trading VaR predominantly resides within Global Markets. This was higher at 31 December 2017 compared to 31 December 2016 due to an increase in the credit trading VaR and interest rate trading VaR, which was driven by increase in the inventory position of the fixed income business.

Risk

Non-trading portfolios

(Unaudited)

Banking book interest rate risk is the risk of an adverse impact to earnings or capital due to changes in market interest rates. The risk arises from timing mismatches in the repricing of non-traded assets and liabilities and is the potential adverse impact of changes in interest rates on earnings and capital. In its management of the risk, the group aims to mitigate the impact of future interest rate movements which could reduce future net interest income, while balancing the cost of hedging activities to the current revenue stream. Monitoring the sensitivity of projected net interest income under varying interest rate scenarios is a key part of this.

In order to manage structural interest rate risk, non-traded assets and liabilities are transferred to Balance Sheet Management ('BSM') based on their repricing and maturity characteristics. For assets and liabilities with no defined maturity or repricing characteristics, behaviouralisation is used to assess the interest rate risk profile. BSM manages the banking book interest rate positions transferred to it within the approved limits. Local ALCOs are responsible for monitoring and reviewing their overall structural interest rate risk position. Interest rate behaviouralisation policies have to be formulated in line with the Group's behaviouralisation policies and approved at least annually by local ALCOs.

Sensitivity of net interest income

A principal part of our management of non-traded interest rate risk is to monitor the sensitivity of expected net interest income at least quarterly under varying interest rate scenarios (simulation modelling), where all other economic variables are held constant.

Sensitivity of net interest income reflects the group's sensitivity of earnings due to changes in market interest rates. Entities forecast net interest income sensitivities across a range of interest rate scenarios based on a static balance sheet assumption. Sites include business line interest rate pass-on assumptions, re-investment of maturing assets and liabilities at market rates per shock scenario and prepayment risk. BSM is modelled based on no management actions i.e. the risk profile at the month end is assumed to remain constant throughout the forecast horizon.

Structural foreign exchange exposures

(Unaudited)

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

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

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

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

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

	LCYm	HK\$m equivalent
At 31 Dec 2017		
Renminbi	181,740	218,262
At 31 Dec 2016		
Renminbi	170,111	189,993

Operational Risk

(Unaudited)

Operational risk is the risk to achieving our strategy or objectives as a result of inadequate or failed internal processes, people and systems or from external events. Responsibility for minimising operational risk lies with HSBC's staff. All staff are required to manage the operational risks of the business and operational activities for which they are responsible.

Operational risk management framework

HSBC's Operational Risk Management Framework ('ORMF') is our overarching approach for managing operational risk, the purpose of which is to:

- identify and manage our operational risks in an effective manner;
- remain within the operational risk appetite, which helps the organisation to understand the level of risk it is willing to accept; and
- drive forward-looking risk awareness and assist management focus.

Business and functional managers throughout the organisation are responsible for maintaining an acceptable level of internal control commensurate with the scale and nature of operations, and for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

A centralised database is used to record the results of the operational risk management process. Operational risk and control self-assessments are input and maintained by business units. Business and functional management and business risk and control managers monitor the progress of documented action plans to address shortcomings. To ensure that operational risk losses are consistently reported and monitored at group level, all group companies are required to report individual losses when the net loss is expected to exceed US\$10,000, and to aggregate all other operational risk losses under US\$10,000. Losses are entered into the Group Operational Risk database and are reported to the group Risk Management Meeting on a monthly basis.

Activities to strengthen our risk culture and better embed the use of the ORMF were further implemented in 2017. In particular, the use of the activity-based 'Three lines of defence' model sets out roles and responsibilities for managing operational risks on a daily basis.

Exposures

(Unaudited)

HSBC continues to strengthen those controls that manage our most material risks by:

- further embedding Global Standards to ensure that we know and protect our customers, ask the right questions and escalate concerns;
- increased monitoring and enhanced detective controls to manage those fraud risks which arise from new technologies and new ways of banking;
- strengthening internal security controls to prevent cyber-attacks;
- improving controls and security to protect customers when using digital channels.
- enhancing controls associated with IT privileged access.

Regulatory Compliance Risk

(Unaudited)

Overview

The Regulatory Compliance ('RC') function provides independent, objective oversight and challenge and promotes a compliance-oriented culture, supporting the business in delivering fair outcomes for customers, maintaining the integrity of financial markets and achieving HSBC's strategic objectives.

Key risk management processes

We regularly review our policies and procedures. Global policies and procedures require the prompt identification and escalation of any actual or potential regulatory breach to RC. Reportable events are escalated to the RMM and the Risk Committee, as appropriate.

Conduct of business

In 2017, we continued to take steps to raise our standards relating to conduct, which included:

- delivering further global mandatory conduct training to all employees in 2018;
- incorporating the assessment of expected values and behaviours as key determinants in recruitment, performance appraisal and remuneration processes;
- improving our Group-wide market surveillance capability;
- introducing policies and procedures to strengthen support for potentially vulnerable customers;
- enhancing the quality and depth of conduct management information and how it is used across the Group;
- implementing an assessment process to check the effectiveness of our conduct initiatives across the Group; and
- assessing conduct standards and practices within our key third-party suppliers and distributors.

Financial Crime Risk

(Unaudited)

Overview

HSBC continued its progress towards implementing an effective financial crime risk management capability across the Group. The Group completed the roll-out of major compliance systems and shifted our focus towards embedding a sustainable approach to financial crime risk management everywhere we operate. This was underpinned by the implementation of a target operating model for the Financial Crime Risk function and by the completion of a country-by-country assessment against our financial crime risk framework.

Key risk management processes

During 2017, HSBC introduced a strengthened financial crime risk management governance framework, mandating Financial Crime Risk Management Committees with a standardised agenda at country, region and global business line levels.

We strengthened our approach to affiliate risk management, implementing an effective Group-level process to assess and remediate affiliate risk, and established a strong investigations and analytical capability to enable us to proactively identify emergent risk issues.

The Monitor

Under the agreements entered into with the US Department of Justice ('DoJ') and the UK Financial Conduct Authority ('FCA') in 2012, including the five-year Deferred Prosecution Agreement ('DPA'), the Monitor was appointed in July 2013 for an expected five-year period to produce annual assessments of the effectiveness of the Group's anti-money laundering ('AML') and sanctions compliance programme. Additionally, under the cease and desist order issued by the US Federal Reserve Board ('FRB') in 2012, the Monitor also serves as an independent consultant to conduct annual assessments.

On 11 December 2017 with the DoJ's agreement, the DPA expired. Consistent with the DPA, the DoJ filed a motion with the US District Court for the Eastern District of New York seeking the dismissal of the charges deferred by the DPA. The motion was granted and the charges were dismissed on 12 December 2017. The Monitor will continue working in his capacity as a Skilled Person and Independent Consultant for a period of time at the FCA's and FRB's discretion.

Reputational Risk

(Unaudited)

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

Reputational risk relates to perceptions, whether based on fact or otherwise. Stakeholders' expectations are constantly changing and thus reputational risk is dynamic and varies between geographies, groups and individuals. As a global bank, we show unwavering commitment to operating, and to be seen to be operating, to the high standards we have set for ourselves in every jurisdiction. Any lapse in standards of integrity, compliance, customer service or operating efficiency represents a potential reputational risk.

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

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

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

Risks of insurance manufacturing operations

(Audited)

The majority of the risk in our insurance business derives from manufacturing activities and can be categorised as financial risk and insurance risk. Financial risks include market risk, credit risk and liquidity risk. Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the issuer (HSBC).

HSBC's bancassurance model

We operate an integrated bancassurance model which provides insurance products principally for customers with whom we have a banking relationship. The insurance contracts we sell relate to the underlying needs of our banking customers, which we can identify from our point-of-sale contacts and customer knowledge. The majority of sales are of savings and investment products.

By focusing largely on personal and small and medium-sized enterprise businesses, we are able to optimise volumes and diversify individual insurance risks.

We choose to manufacture these insurance products in HSBC subsidiaries based on an assessment of operational scale and risk appetite. Manufacturing insurance allows us to retain the risks and rewards associated with writing insurance contracts by keeping part of the underwriting profit and investment income within the group. It also reduces distribution costs for our products by using our established branch network, and enables us to control the quality of the sale process and the products themselves to ensure our customers receive products which address their specific needs at the best value. We have life insurance manufacturing operations in six locations: mainland China, Hong Kong, India, Macau, Malaysia and Singapore.

Where we do not have the risk appetite or operational scale to be an effective insurance manufacturer, we engage with a handful of leading external insurance companies in order to provide insurance products to our customers through our banking network and direct channels. These arrangements are generally structured with our exclusive strategic partners and earn the group a combination of commissions, fees and a share of profits. We distribute insurance products in all of our geographical regions. Insurance products are sold through all global businesses, but predominantly by RBWM and CMB through our branches and direct channels.

Risk management of insurance manufacturing operations

Governance

Insurance risks are managed to a defined risk appetite, which is aligned to the Group risk appetite and risk management framework, including the Group's 'Three lines of defence' model. The group Insurance Risk Management Meeting oversees the control framework globally and is accountable to the RBWM Risk Management Meeting on risk matters relating to insurance business.

The monitoring of the risks within the insurance operations is carried out by the Insurance Risk teams. Specific risk functions, including wholesale credit & market risk, operational risk, information security risk and financial crime compliance, support insurance risk teams in their respective areas of expertise.

Measurement

The risk profile of our insurance manufacturing businesses is measured using an economic capital approach. Assets and liabilities are measured on a market value basis and a capital requirement is defined to ensure that there is a less than one-in-200 chance of insolvency over a one-year time horizon, given the risks that the businesses are exposed to. The methodology for the economic capital calculation is largely aligned to the pan-European Solvency II insurance capital regulation. The economic capital coverage ratio (economic net asset value divided by the economic capital requirement) is a key risk appetite measure. In addition to economic capital, the regulatory solvency ratio is also a metric used to manage risk appetite on an entity basis.

The tables below show the composition of assets and liabilities by contract type. 91% (2016: 92%) of both assets and liabilities are derived from Hong Kong.

Balance sheet of insurance manufacturing subsidiaries by type of contract

	Non-linked contracts ¹	Linked contracts ²	Other assets and liabilities ³	Total
	HK\$m	HK\$m	HK\$m	HK\$m
At 31 Dec 2017				
Financial assets:				
– financial assets designated at fair value	66,497	53,408	2,278	122,183
– derivatives	1,336	1	2	1,339
– financial investments – held-to-maturity	274,909	–	26,034	300,943
– financial investments – available-for-sale	49,268	–	695	49,963
– other financial assets	23,599	1,398	3,671	28,668
Total financial assets	415,609	54,807	32,680	503,096
Reinsurance assets	15,974	155	–	16,129
PVIF	–	–	44,621	44,621
Other assets	8,279	4	4,026	12,309
Total assets	439,862	54,966	81,327	576,155
Liabilities under investment contracts designated at fair value	30,364	7,905	–	38,269
Liabilities under insurance contracts	391,348	46,669	–	438,017
Deferred tax	409	–	7,668	8,077
Other liabilities	–	–	12,330	12,330
Total liabilities	422,121	54,574	19,998	496,693
Total equity	–	–	79,462	79,462
Total equity and liabilities	422,121	54,574	99,460	576,155
At 31 Dec 2016				
Financial assets:				
– financial assets designated at fair value	56,863	48,644	107	105,614
– derivatives	660	17	1	678
– financial investments – held-to-maturity	238,126	–	22,641	260,767
– financial investments – available-for-sale	43,412	–	1,071	44,483
– other financial assets	24,194	1,091	3,955	29,240
Total financial assets	363,255	49,752	27,775	440,782
Reinsurance assets	10,321	1,308	–	11,629
PVIF	–	–	44,077	44,077
Other assets	7,665	3	3,894	11,562
Total assets	381,241	51,063	75,746	508,050
Liabilities under investment contracts designated at fair value	29,511	6,792	–	36,303
Liabilities under insurance contracts	342,134	44,036	–	386,170
Deferred tax	159	–	6,981	7,140
Other liabilities	–	–	10,540	10,540
Total liabilities	371,804	50,828	17,521	440,153
Total equity	–	–	67,897	67,897
Total equity and liabilities	371,804	50,828	85,418	508,050

¹ Comprises life non-linked insurance contracts, non-linked investment contracts and remaining non-life insurance contracts.

² Comprises life linked insurance contracts and linked investment contracts.

³ Comprises shareholder assets and liabilities.

Stress and scenario testing

Stress testing forms a key part of the risk management framework for the insurance business. We participate in local and Group-wide regulatory stress tests, including the Bank of England stress test of the banking system, the Hong Kong Monetary Authority stress test, and individual country insurance regulatory stress tests.

These have highlighted that a key risk scenario for the insurance business is a prolonged low interest rate environment. In order to mitigate the impact of this scenario, the insurance operations have a range of strategies that could be employed including the hedging of investment risk, repricing current products to reflect lower interest rates, improving risk diversification, moving towards less capital intensive products, and developing investment strategies to optimise the expected returns against the cost of economic capital.

Key Risk Types

The key risks for our insurance operations are market risks (in particular interest rate and equity) and credit risks, followed by insurance underwriting risks and operational risks. Liquidity risk, while significant for the bank, is minor for our insurance operations.

Market risk (insurance)

Market risk is the risk of changes in market factors affecting

capital or profit. Market factors include interest rates, equity and growth assets and foreign exchange rates.

Our exposure varies depending on the type of contract issued. Our most significant life insurance products are contracts with discretionary participating features ('DPF') issued in Hong Kong. These products typically include some form of capital guarantee or guaranteed return, on the sums invested by the policyholders, to which discretionary bonuses are added if allowed by the overall performance of the funds. These funds are primarily invested in bonds with a proportion allocated to other asset classes, to provide customers with the potential for enhanced returns.

DPF products expose HSBC to the risk of variation in asset returns, which will impact our participation in the investment performance. In addition, in some scenarios the asset returns can become insufficient to cover the policyholders' financial guarantees, in which case the shortfall has to be met by HSBC. Reserves are held against the cost of such guarantees, calculated by stochastic modelling.

For unit-linked contracts, market risk is substantially borne by the policyholders, but some market risk exposure typically remains as fees earned are related to the market value of the linked assets.

All our insurance manufacturing subsidiaries have market risk mandates which specify the investment instruments in which they are permitted to invest and the maximum quantum of market risk which they may retain. They manage market risk by using, among

Risk

others, some or all of the techniques listed below, depending on the nature of the contracts written:

- For products with DPF, adjusting bonus rates to manage the liabilities to policyholders. The effect is that a significant portion of the market risk is borne by the policyholders.
- Asset and liability matching where asset portfolios are structured to support projected liability cash flows. The group manages its assets using an approach that considers asset quality, diversification, cash flow matching, liquidity, volatility and target investment return. It is not always possible to match asset and liability durations due to uncertainty over the receipt of all future premiums and the timing of claims; and because the forecast payment dates of liabilities may exceed the duration of the longest dated investments available. We use models to assess the effect of a range of future scenarios on the values of financial assets and associated liabilities, and ALCOs employ the outcomes in determining how best to structure asset holdings to support liabilities.

- Using derivatives to protect against adverse market movements or better match liability cash flows.
- For new products with investment guarantees, considering the cost when determining the level of premiums or the price structure.
- Periodically reviewing products identified as higher risk, which contain investment guarantees and embedded optionality features linked to savings and investment products for active management.
- Designing new products to mitigate market risk, such as changing the investment return sharing portion between policyholders and the shareholder.
- Exiting, to the extent possible, investment portfolios whose risk is considered unacceptable.
- Repricing premiums charged to policyholders.

The following table illustrates the effects of selected interest rate, equity price and foreign exchange rate scenarios on our profit for the year and the total equity of our insurance manufacturing subsidiaries.

	31 Dec 2017		31 Dec 2016	
	Impact on profit after tax for the year	Impact on total equity	Impact on profit after tax for the year	Impact on total equity
	HK\$m	HK\$m	HK\$m	HK\$m
+100 basis points parallel shift in yield curves	97	(4,525)	(56)	(4,137)
-100 basis points parallel shift in yield curves	(651)	4,976	(371)	4,575
10% increase in equity prices	1,534	1,643	1,345	1,347
10% decrease in equity prices	(1,560)	(1,669)	(1,354)	(1,357)
10% increase in USD exchange rate compared to all currencies	177	177	143	143
10% decrease in USD exchange rate compared to all currencies	(177)	(177)	(143)	(143)

Where appropriate, the effects of the sensitivity tests on profit after tax and total equity incorporate the impact of the stress on the PVIF. The relationship between the profit and total equity and the risk factors is non-linear; therefore the results disclosed should not be extrapolated to measure sensitivities to different levels of stress. For the same reason, the impact of the stress is not symmetrical on the upside and downside. The sensitivities reflect the established risk sharing mechanism with policyholders for participating products, and are stated before allowance for management actions which may mitigate the effect of changes in the market environment. The sensitivities presented allow for adverse changes in policyholders' behaviour that may arise in response to changes in market rates.

Interest rate movements have a greater impact on total equity as changes in market value of available-for-sale bonds are not recognised in profit after tax.

Credit risk (insurance)

Credit risk is the risk of financial loss if a customer or counterparty fails to meet their obligation under a contract. It arises in two main areas for our insurance manufacturers:

- risk associated with credit spread volatility and default by debt security counterparties after investing premiums to generate a return for policyholders and shareholders; and
- risk of default by reinsurance counterparties and non-reimbursement for claims made after ceding insurance risk.

The amounts outstanding at the balance sheet date in respect of these items are shown in the table on page 31.

Our insurance manufacturing subsidiaries are responsible for the credit risk, quality and performance of their investment portfolios. Our assessment of the creditworthiness of issuers and counterparties is based primarily upon internationally recognised credit ratings and other publicly available information. Investment credit exposures are monitored against limits by our local insurance manufacturing subsidiaries, and are aggregated and reported to Group Insurance Credit Risk and Group Credit Risk functions. Stress testing is performed by Group Insurance on investment credit exposures using credit spread sensitivities and

default probabilities.

We use tools to manage and monitor credit risk. These include a credit report containing a watch-list of investments with current credit concerns, primarily investments that may be at risk of future impairment or where high concentrations to counterparties are present in the investment portfolio. The report is circulated monthly to senior management in Group Insurance and the individual country Chief Risk Officers to identify investments which may be at risk of future impairment.

Credit risk on assets supporting unit-linked liabilities is predominantly borne by the policyholders; therefore our exposure is primarily related to liabilities under non-linked insurance and investment contracts and shareholders' funds. The credit quality of insurance financial assets is included in the table on page 20.

The credit quality of the reinsurers' share of liabilities under insurance contracts is assessed as 'strong' or 'good' (as defined on page 19), with 100% of the exposure being neither past due nor impaired (2016: 100%).

Liquidity risk (insurance)

Liquidity risk is the risk that an insurance operation, though solvent, either does not have sufficient financial resources available to meet its obligations when they fall due, or can secure them only at excessive cost.

Risk is managed by cashflow matching and maintaining sufficient cash resources; investing in high-credit-quality investments with deep and liquid markets, monitoring investment concentrations and restricting them where appropriate, and establishing committed contingency borrowing facilities. Insurance manufacturing subsidiaries are required to complete quarterly liquidity risk reports for Group Insurance Risk function and an annual review of the liquidity risks to which they are exposed.

The following table shows the expected undiscounted cash flows for insurance contract liabilities at 31 December 2017. The liquidity risk exposure is wholly borne by the policyholders in the case of unit-linked business and is shared with the policyholders for non-linked insurance. The remaining contractual maturity of investment contract liabilities is included in the table on page 81.

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				Total HK\$m
	Within 1 year	1-5 years	5-15 years	Over 15 years	
	HK\$m	HK\$m	HK\$m	HK\$m	
At 31 Dec 2017					
Non-linked insurance contracts	37,445	133,236	268,173	291,343	730,197
Linked insurance contracts	4,523	20,357	32,084	48,606	105,570
	41,968	153,593	300,257	339,949	835,767
At 31 Dec 2016					
Non-linked insurance contracts	28,980	118,623	255,449	252,421	655,473
Linked insurance contracts	3,025	16,492	35,559	70,238	125,314
	32,005	135,115	291,008	322,659	780,787

Insurance risk

Insurance risk is the risk of loss through adverse experience, in either timing or amount, of insurance underwriting parameters (non-economic assumptions). These parameters include mortality, morbidity, longevity, lapses and unit costs.

The principal risk we face is that, over time, the cost of the contract, including claims and benefits may exceed the total amount of premiums and investment income received. The table on page 32 analyses our life insurance risk exposures by type of contract.

HSBC Insurance primarily manages and mitigates its insurance risk through asset and liability management, product design, pricing and overall proposition management (e.g. management of lapses by introducing surrender charges), underwriting policy, claims management process and reinsurance which cedes risks above our acceptable thresholds to an external reinsurer thereby limiting our exposure.

Present value of in-force long-term insurance business

In calculating PVIF, expected cash flows are projected after adjusting for a variety of assumptions made by each insurance operation to reflect local market conditions and management's judgement of future trends, and after applying risk margins to reflect any uncertainty in the underlying assumptions. Variations in actual experience and changes to assumptions can contribute to volatility in the results of the insurance business.

Actuarial Control Committees for each key insurance entity meet on a quarterly basis to review and approve assumptions proposed for use in the determination of the PVIF. All changes to non-economic assumptions, economic assumptions that are not observable and model methodology must be approved by the Actuarial Control Committee.

Economic assumptions are either set in a way that is consistent with observable market values or, in certain markets, long-term economic assumptions are used. Setting such assumptions involves the projection of long-term interest rates and the time horizon over which observable market rates trend towards these

long-term assumptions. The assumptions are informed by relevant historical data and by research and analysis performed by the Group's Economic Research team and external experts, including regulatory bodies. The valuation of PVIF will be sensitive to any changes in these long-term assumptions in the same way that it is sensitive to observed market movements, and the impact of such changes is included in the sensitivities presented below.

The group sets the risk discount rate applied to the PVIF calculation by starting from a risk-free rate curve and adding explicit allowances for risks not reflected in the best estimate cash flow modelling. Where shareholders provide options and guarantees to policyholders, the cost of these options and guarantees is an explicit reduction to PVIF.

The following table shows the impact on the PVIF from changes in the risk-free rate at 31 December, across all insurance manufacturing subsidiaries.

	Impact on PVIF	
	2017 HK\$m	2016 HK\$m
+ 100 basis points shift in risk-free rate	166	67
- 100 basis points shift in risk-free rate	1,513	379

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

Non-economic assumptions

The table below shows the sensitivity of profit and total equity to reasonably possible changes in non-economic assumptions across all our insurance manufacturing subsidiaries.

	Impact on 2017 results		Impact on 2016 results	
	Profit after tax	Total equity	Profit after tax	Total equity
	HK\$m	HK\$m	HK\$m	HK\$m
10% increase in mortality and/or morbidity rates	(454)	(454)	(464)	(464)
10% decrease in mortality and/or morbidity rates	459	459	467	467
10% increase in lapse rates	(434)	(434)	(398)	(398)
10% decrease in lapse rates	495	495	452	452
10% increase in expense rates	(328)	(328)	(331)	(331)
10% decrease in expense rates	315	315	318	318

Mortality and morbidity risk is typically associated with life insurance contracts. The effect on profit of an increase in mortality or morbidity depends on the type of business being written.

Sensitivity to lapse rates depends on the type of contracts being written. In general, for life insurance contracts a policy lapse has two offsetting effects on profits, which are the loss of future income on the lapsed policy and the existence of surrender charge

recouped at policy lapse. The net impact depends on the relative size of these two effects which varies with the type of contracts.

Expense rates risk is the exposure to a change in the cost of administering insurance contracts. To the extent that increased expenses cannot be passed on to policyholders, an increase in expense rates will have a negative effect on our profits.

Capital

Capital Management

(Audited)

Our approach to capital management is driven by our strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which we operate.

It is our objective to maintain a strong capital base to support the development of our business and to meet regulatory capital requirements at all times. To achieve this, our policy is to hold capital in a range of different forms and all capital raising is agreed with major subsidiaries as part of their individual and the group's capital management processes.

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

Capital measures:

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

Our capital management process is articulated in our annual capital plan which is approved by the Board. The plan is drawn up with the objective of maintaining both an appropriate amount of capital and an optimal mix between the different components of capital. Each subsidiary manages its own capital to support its planned business growth and meet its local regulatory requirements within the context of the approved annual group capital plan. In accordance with the Capital Management Framework, capital generated by subsidiaries in excess of planned requirements is returned to the Bank, normally by way of dividends.

The Bank is primarily the provider of capital to its subsidiaries and these investments are substantially funded by the Bank's own capital issuance and profit retention. As part of its capital management process, the Bank seeks to maintain a prudent balance between the composition of its capital and that of its investment in subsidiaries.

The principal forms of capital are included in the following balances on the consolidated balance sheet: share capital, other equity instruments, retained earnings, other reserves, preference shares and subordinated liabilities.

Externally imposed capital requirements

(Unaudited)

The Hong Kong Monetary Authority ('HKMA') supervises the group on both a consolidated and solo-consolidated basis and therefore receives information on the capital adequacy of, and sets capital requirements for, the group as a whole and on a solo-consolidated basis. Individual banking subsidiaries and branches are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements. In most jurisdictions, non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

The group uses the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures and the internal ratings-based (securitisation) approach to determine credit risk for its banking book securitisation exposures. For market risk, the group uses an internal models approach to calculate its general market risk for the risk categories of interest rate exposures, foreign exchange (including gold) exposures, and equity exposures. The group also uses an internal models approach to calculate its market risk in respect of specific

risk for interest rate exposures and equity exposures. The group uses the standardised (market risk) approach for calculating other market risk positions as well as trading book securitisation exposures, and the standardised (operational risk) approach to calculate its operational risk.

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

Basel III

(Unaudited)

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

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

The Banking (Capital) (Amendment) Rules 2014 came into effect on 1 January 2015 to implement the Basel III capital buffer requirements in Hong Kong. The changes include the phase-in from 2016 to 2019 of the Capital Conservation Buffer ('CCB') which is designed to ensure banks build up capital outside periods of stress of 2.5% of RWAs, the Countercyclical Capital Buffer ('CCyB') which is set on an individual country basis and is built up during periods of excess credit growth to protect against future losses, and the Higher Loss Absorbency ('HLA') requirement for Domestic Systemically Important Banks ('D-SIB') of up to 3.5% of RWAs. The CCyB for Hong Kong is 1.25% from 1 January 2017 and 1.875% from 1 January 2018. The HKMA announced on 10 January 2018 that it will be increased to 2.5% from 1 January 2019. This increase is consistent with the Basel III phase-in arrangements for the CCyB. On 16 March 2015, the HKMA announced the designation of the group as a D-SIB and the HLA requirement to be 2.5% of RWAs which started to phase-in from 0.625% in 2016 and will reach full implementation in 2019. On 29 December 2017, the HKMA confirmed the designation of the group as a D-SIB as well as the HLA requirements.

Total Loss Absorbing Capacity proposals

(Unaudited)

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

Leverage Ratio

(Unaudited)

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

Basel III provides for a transitional period for the introduction of this ratio, comprising a supervisory monitoring period that started in 2011 and a parallel run period from January 2013 and completed by 2017. The Banking (Capital) (Amendment) Rules 2017 came into effect on 1 January 2018. This includes the implementation of the leverage ratio framework in Hong Kong with the minimum leverage ratio requirement of 3%.

	At	
	31 Dec 2017	31 Dec 2016
	%	%
Leverage ratio	6.3	6.3
Capital and leverage ratio exposure measure	HK\$m	HK\$m
Tier 1 capital	468,021	444,872
Total exposure measure	7,477,306	7,018,046

Leverage ratio at 31 December 2017 remained stable compared with 31 December 2016. Further details regarding the group's leverage positions can be viewed in the Banking Disclosure Statement 2017, which will be available in the Regulatory Disclosures section of our website: www.hsbc.com.hk.

Capital adequacy at 31 December 2017

(Unaudited)

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

The basis of consolidation for financial accounting purposes is described in note 1 on the Financial Statements and differs from that used for regulatory purposes. Further information on the regulatory consolidation basis and a full reconciliation between the group's accounting and regulatory balance sheets can be viewed in the Banking Disclosure Statement 2017, which will be available in the Regulatory Disclosures section of our website www.hsbc.com.hk. Subsidiaries not included in the group's consolidation for regulatory purposes are securities and insurance companies and the capital invested by the group in these subsidiaries is deducted from regulatory capital, subject to certain thresholds.

The Bank and its banking subsidiaries maintain regulatory reserves to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2017, the effect of this requirement is to reduce the amount of reserves which can be distributed to shareholders by HK\$27,703m (31 December 2016: HK\$25,931m).

There are no relevant capital shortfalls in any of the group's subsidiaries at 31 December 2017 (31 December 2016: nil) which are not included in its consolidation group for regulatory purposes.

Capital ratios

(Unaudited)

	At	
	31 Dec 2017	31 Dec 2016
	%	%
Common equity tier 1 ('CET1') capital ratio	15.9	16.0
Tier 1 capital ratio	17.0	17.2
Total capital ratio	18.9	19.0

Risk-weighted assets by risk type

(Unaudited)

	At	
	31 Dec 2017	31 Dec 2016
	HK\$m	HK\$m
Credit risk	2,205,845	2,027,690
Counterparty credit risk	134,793	171,150
Market risk	115,081	90,454
Operational risk	302,890	299,295
Total	2,758,609	2,588,589

Risk-weighted assets by global business

(Unaudited)

	At	
	31 Dec 2017	31 Dec 2016
	HK\$m	HK\$m
Retail Banking and Wealth Management	404,771	365,094
Commercial Banking	927,472	832,810
Global Banking and Markets	951,294	899,276
Global Private Banking	29,983	27,262
Corporate Centre	445,089	464,147
Total	2,758,609	2,588,589

Capital Base

(Unaudited)

The following table sets out the composition of the group's capital base under Basel III at 31 December 2017. The position at 31 December 2017 benefits from transitional arrangements which will be phased out.

Capital

Capital base

(Unaudited)

	At	
	31 Dec 2017 HK\$m	31 Dec 2016 HK\$m
Common equity tier 1 ('CET1') capital		
Shareholders' equity	610,307	551,776
– shareholders' equity per balance sheet	696,480	628,006
– revaluation reserve capitalisation issue	(1,454)	(1,454)
– other equity instruments	(14,737)	(14,737)
– unconsolidated subsidiaries	(69,982)	(60,039)
Non-controlling interests	24,416	22,676
– non-controlling interests per balance sheet	56,506	51,130
– non-controlling interests in unconsolidated subsidiaries	(8,590)	(6,442)
– surplus non-controlling interests disallowed in CET1	(23,500)	(22,012)
Regulatory deductions to CET1 capital	(196,030)	(160,144)
– valuation adjustments	(1,485)	(2,020)
– goodwill and intangible assets	(15,347)	(14,029)
– deferred tax assets net of deferred tax liabilities	(2,237)	(1,566)
– cash flow hedging reserve	135	222
– changes in own credit risk on fair valued liabilities	(183)	(1,195)
– defined benefit pension fund assets	(79)	(62)
– significant capital investments in unconsolidated financial sector entities	(86,046)	(57,395)
– property revaluation reserves ¹	(63,085)	(58,168)
– regulatory reserve	(27,703)	(25,931)
Total CET1 capital	438,693	414,308
Additional tier 1 ('AT1') capital		
Total AT1 capital before regulatory deductions	39,203	47,897
– perpetual subordinated loans	14,737	14,737
– perpetual non-cumulative preference shares	19,367	25,228
– allowable non-controlling interests in AT1 capital	5,099	7,932
Regulatory deductions to AT1 capital	(9,875)	(17,333)
– significant capital investments in unconsolidated financial sector entities	(9,875)	(17,333)
Total AT1 capital	29,328	30,564
Total tier 1 capital	468,021	444,872
Tier 2 capital		
Total tier 2 capital before regulatory deductions	67,874	67,536
– perpetual cumulative preference shares	1,563	1,551
– perpetual subordinated debt	3,126	3,102
– term subordinated debt	18,418	21,472
– property revaluation reserves ¹	29,043	26,830
– impairment allowances and regulatory reserve eligible for inclusion in tier 2 capital	15,724	14,581
Regulatory deductions to tier 2 capital	(13,651)	(21,106)
– significant capital investments in unconsolidated financial sector entities	(13,651)	(21,106)
Total tier 2 capital	54,223	46,430
Total capital	522,244	491,302

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

A detailed breakdown of the group's CET1 capital, AT1 capital, Tier 2 capital and regulatory deductions can be viewed in the Banking Disclosure Statement 2017, which will be available in the Regulatory Disclosures section of our website www.hsbc.com.hk.

The following table shows the pro-forma Basel III end point basis position once all transitional arrangements have been phased out based on the Transition Disclosures Template. It should be noted that the pro-forma Basel III end point basis position takes no account of, for example, any future profits or management actions. In addition, the current regulations or their application may change before full implementation. Given this, the final

impact on the group's capital ratios may differ from the pro-forma position, which is a mechanical application of the current rules to the balance sheet at 31 December 2017; it is not a projection. On this pro-forma basis, the group's CET1 ratio is 15.2% (2016: 14.7%), which is above the Basel III minimum requirement, plus expected regulatory capital buffer requirements.

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

(Unaudited)

	At	
	31 Dec 2017 HK\$m	31 Dec 2016 HK\$m
CET1 capital on a transitional basis	438,693	414,308
Transitional provisions: Significant capital investments in unconsolidated financial sector entities	(19,750)	(34,666)
CET1 capital end point basis	418,943	379,642
AT1 capital on a transitional basis	29,328	30,564
Grandfathered instruments: Perpetual non-cumulative preference shares	(19,367)	(25,228)
Transitional provisions:	6,406	10,799
Allowable non-controlling interests in AT1 capital	(3,469)	(6,534)
Significant capital investments in unconsolidated financial sector entities	9,875	17,333
AT1 capital end point basis	16,367	16,135
Tier 2 capital on a transitional basis	54,223	46,430
Grandfathered instruments:	(5,287)	(6,115)
Perpetual cumulative preference shares	(1,563)	(1,551)
Perpetual subordinated debt	(3,126)	(3,102)
Term subordinated debt	(598)	(1,462)
Transitional provisions: Significant capital investments in unconsolidated financial sector entities	9,875	17,333
Tier 2 capital end point basis	58,811	57,648

Statement of Directors' Responsibilities

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on pages 39-44, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditor in relation to the Financial Statements.

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

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

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

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

The Directors, whose names and functions are set out in the 'Report of the Directors' on pages 3-8 of this *Annual Report and Accounts*, confirm to the best of their knowledge that:

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

On behalf of the Board

Stuart Gulliver

Chairman

20 February 2018

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

Opinion

What we have audited

The consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together, 'the group') set out on pages 46 to 97, which comprise the:

- consolidated balance sheet as at 31 December 2017;
- consolidated income statement for the year then ended;
- consolidated statement of comprehensive income for the year then ended;
- consolidated statement of changes in equity for the year then ended;
- consolidated statement of cash flows for the year then ended; and
- notes on the consolidated financial statements, which include a summary of significant accounting policies.

Our opinion

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the group as at 31 December 2017, and of its consolidated financial performance and consolidated cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ('HKFRSs') issued by the Hong Kong Institute of Certified Public Accountants ('HKICPA') and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ('HKSA's') issued by the HKICPA. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We are independent of the group in accordance with the HKICPA's Code of Ethics for Professional Accountants ('the Code'), and we have fulfilled our other ethical responsibilities in accordance with the Code.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the consolidated financial statements for the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key audit matters identified in our audit are summarised as follows:

- IT access management
- Investment in associate – Bank of Communications Co., Limited ('BoCom')
- The present value of in-force long-term insurance business ('PVIF') and liabilities under non-linked life insurance contracts
- Impairment of loans and advances to customers
- HKFRS 9 expected credit losses
- The impact of HSBC's strategic actions

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

IT Access Management

Nature of the Key Audit Matter	Matters discussed with the Audit Committee
<p>All banks are highly dependent on technology due to the significant number of transactions that are processed daily. The audit approach relies extensively on automated controls and therefore on the effectiveness of controls over IT systems.</p> <p>In the previous year, we identified and reported that the entity's controls over access to applications, operating systems and data in the financial reporting process required improvements. Access management controls are critical to ensure that changes to applications and underlying data are made in an appropriate manner. Appropriate access controls contribute to mitigating the risk of potential fraud or errors as a result of changes to applications and data.</p> <p>Management implemented several remediation activities that contributed to reducing the risk over access management in the financial reporting process. These included implementation of group-wide preventative and detective controls across critical applications and infrastructure. However, due to the pervasive nature of access management issues, we continued to assess the risk of a material misstatement arising from access to technology as significant for the audit.</p>	<p>The status on remediation of access controls was discussed at several Audit Committee meetings during the year.</p> <p>Controls were enhanced during 2017 to respond to our audit findings and to reduce the risks over privileged access to IT infrastructure such as databases and operating systems. However, given the scale and complexity of the remediation, there were still actions to be taken during the year to ensure that controls are fully embedded and operate effectively.</p> <p>By the end of the financial year, management had put in place controls to address the critical operating system and database related matters previously reported. Management continue to progress remediation relating to the management of business application access.</p>
How our audit addressed the Key Audit Matter	
<p>Access rights were tested over applications, operating systems and databases relied upon for financial reporting. Specifically, the audit tested that:</p> <ul style="list-style-type: none">• new access requests for joiners were properly reviewed and authorised;• user access rights were removed on a timely basis when an individual left or moved role;• access rights to applications, operating systems and databases were periodically monitored for appropriateness; and• highly privileged access is restricted to appropriate personnel. <p>Other areas that were independently assessed included password policies, security configurations, controls over changes to applications and databases; and that business users, developers and production support personnel did not have access to change applications, the operating system or databases in the production environment.</p> <p>As a consequence of deficiencies identified in the controls, a range of other procedures were performed:</p> <ul style="list-style-type: none">• where inappropriate access was identified, we understood the nature of the access, and obtained additional evidence on the appropriateness of the activities performed;• additional substantive testing was performed on specific year-end reconciliations (i.e. custodian, bank account and suspense account reconciliations) and confirmations with external counterparties;• testing was performed on other compensating controls such as business performance reviews;• testing was performed over controls that prevent inappropriate combinations of access; and• a list of users' access permissions was obtained and manually compared to other access lists where segregation of duties was deemed to be of higher risk, for example users having access to general ledger systems. <p>A significant amount of the group's technology processes and controls were undertaken in shared service centres located outside of Hong Kong. Our audit testing of access rights controls was also performed in the shared service centre locations.</p>	
Relevant references in the Annual Report and Accounts 2017	
Risk: Top and Emerging Risks, page 16; Operational Risk, page 28	

Investment in associate – Bank of Communications Company, Limited ('BoCom')

Nature of the Key Audit Matter	Matters discussed with the Audit Committee
<p>The Bank's investment in BoCom is accounted for as an associate, using the equity method.</p> <p>For seven consecutive year ends, the market value of BoCom has been below the carrying value. At 31 December 2017, the market value based on the share price was HK\$59.7bn lower than the carrying value.</p> <p>This is considered an indicator of potential impairment under HKFRS. An impairment test was performed by the Bank using a value in use model to estimate the investment's value assuming it continues to be held in perpetuity rather than sold. On this basis, no impairment was recorded and the share of BoCom's profits has been recognised in the consolidated income statement. The value in use model determines the present value of the Bank's share of BoCom's future cash flows. The model is dependent on many assumptions, both short-term and long-term in nature. These assumptions are derived from a combination of management estimates, analysts' forecasts and market data, and are highly judgemental.</p>	<p>Discussions with the Audit Committee were focused on:</p> <ul style="list-style-type: none"> the continued appropriateness of the value in use model given the period of time that the carrying value has been in excess of market value; the key assumptions used in the model with a particular focus on the assumptions with the highest level of uncertainty. Following these discussions, the long-term profit growth rate, discount rate and long-term asset growth rate assumptions were reassessed and updated; and the reasonably possible alternative assumptions, particularly where they had the most impact on the value in use calculation. <p>At 31 December, the Bank confirmed its view that the model and assumptions were appropriate and not inconsistent with information obtained in its capacity as a shareholder and board member of BoCom.</p>
How our audit addressed the Key Audit Matter	
<ul style="list-style-type: none"> With the assistance of our valuation experts, the appropriateness of the model was reviewed and the discount rate used within the model was independently recalculated. Inputs used in the determination of assumptions within the model were challenged and corroborating information was obtained with reference to external market information, third-party sources including analyst reports, and historical publicly available BoCom information. The controls in place over the model were tested, including senior management review controls over the inputs, assumptions and output of the model. A meeting in September 2017 between management and senior BoCom executive management, held specifically to identify facts or circumstances impacting management assumptions, was observed. The mathematical accuracy of the model was tested. Disclosures made in the <i>Annual Report and Accounts 2017</i> in relation to BoCom were reviewed. 	
Relevant references in the Annual Report and Accounts 2017	
<p>Financial Review, page 11</p> <p>Note 1: Basis of preparation and significant accounting policies, page 53</p> <p>Note 15: Interests in associates and joint ventures, page 72-75</p>	

The present value of in-force long-term insurance business ('PVIF') and liabilities under non-linked life insurance contracts

Nature of the Key Audit Matter	Matters discussed with the Audit Committee
<p>The group has recorded an asset for PVIF of HK\$44,621 million and liabilities under non-linked life insurance contracts of HK\$391,348 million as at 31 December 2017.</p> <p>The determination of these balances requires the use of appropriate actuarial methodologies and also highly judgemental assumptions. Such assumptions include the long-term economic returns of insurance contracts issued, assumptions over policyholder behaviour such as longevity, mortality and persistency, and management assumptions over the future costs of obtaining and maintaining the group's insurance business.</p> <p>Small movements in these assumptions can have a material impact on the PVIF asset and the liabilities under non-linked life insurance contracts.</p>	<p>We discussed with the Audit Committee the results of our testing procedures over key assumptions used in the valuation of the PVIF asset and the liabilities under non-linked life insurance contracts including testing of changes made during the reporting period to the models and to the basis of the determination of key assumptions.</p>
How our audit addressed the Key Audit Matter	
<p>The controls that management had established over the valuation of the PVIF asset and the liabilities under non-linked life insurance contracts were tested. These included controls over policy data reconciliations from the policyholder administration system to the actuarial valuation system, controls over assumption setting, controls over the review and determination of valuation methodology, system access and user acceptance testing controls over the actuarial models used, and controls over the production and approval of the actuarial results.</p> <p>The appropriateness of the models, methodologies and assumptions used (including assumptions over the long-term economic returns of insurance contracts issued, assumptions over policyholder behaviour such as longevity, mortality and persistency, and assumptions relating to future costs of obtaining and maintaining the insurance business) were reviewed with the assistance of our actuarial experts.</p> <p>Management's key judgements and assumptions were evaluated and challenged with the assistance of our actuarial experts. Our challenge and evaluation included whether these judgements were supported by relevant experience, market information and formed a reasonable basis for setting the assumptions.</p>	
Relevant references in the Annual Report and Accounts 2017	
<p>Risk: Risks of insurance manufacturing operations, page 30-33</p> <p>Note 1: Basis of preparation and significant accounting policies, page 58</p> <p>Note 16: Goodwill and intangible assets, page 76</p> <p>Note 24: Liabilities under insurance contracts, page 79</p>	

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

Impairment of loans and advances to customers

Nature of the Key Audit Matter	Matters discussed with the Audit Committee
<p>Impairment allowances represent management's best estimate of the losses incurred within the loan portfolios at the balance sheet date. They are calculated on a collective basis for portfolios of loans of a similar nature and on an individual basis for significant impaired loans. The calculation of both collective and individual impairment allowances is inherently judgemental for any bank.</p> <p>Collective impairment allowances are calculated using models which approximate the impact of current economic and credit conditions on large portfolios of loans. The inputs to these models are based on historical loss experience with judgement applied to determine the assumptions used to calculate impairment. Model overlays are applied where data driven parameters or calculations are not considered representative of current risks or conditions of the loan portfolios.</p> <p>For specific impairments, judgement is required to determine when an impairment event has occurred and then to estimate the expected future cash flows related to that loan. The audit focus was primarily on wholesale impairment due to the materiality of the loan balances and associated impairment allowances, and the subjective nature of the impairment calculation.</p>	<p>We discussed with the Audit Committee details of our testing procedures and our findings over individual and collective impairment allowances. We also discussed with the Audit Committee changes to risk factors relevant to the collective allowance models as well as judgements made on individually significant loan impairments and the compliance of these changes and judgements with accounting standards.</p>
How our audit addressed the Key Audit Matter	
<p>For collective impairment allowances, controls over the completeness and accuracy of the data input to the models were tested. Controls over the appropriateness of the models used to determine the impairment allowance and management review controls of key assumptions to the models were tested.</p> <p>The appropriateness of the collective modelling methodology was independently assessed by reference to the accounting standards and model calculations were tested through re-performance.</p> <p>The appropriateness of management's judgements was also independently assessed with respect to calculation methodology and segmentation, economic factors and judgemental overlays, the period of historical loss rates and loss emergence periods used.</p> <p>For impairment allowances on individual loans, the controls over credit file review processes, the reasonableness of cash flow assumptions for impaired loans, the approval of external collateral valuation vendors, and controls over the approval and recording of significant individual impairment charges were tested.</p> <p>For impairment allowances on individual loans, the appropriateness of provisioning methodologies and policies was independently assessed for a sample of loans. An independent view was formed on the level of allowances booked based on review of the detailed loan, security and counterparty information in the credit files, including management's evidence to determine when the impairment event occurred and, where available, independently obtained market information. Calculations within a sample of discounted cash flows were re-performed.</p>	
Relevant references in the Annual Report and Accounts 2017	
<p>Risk: Credit Risk, page 17-24 Note 1: Basis of preparation and significant accounting policies, page 55 Note 2: Operating profit - Loan impairment charges and other credit risk provisions, page 61 Note 11: Impairment of loans and advances to customers, page 70</p>	

HKFRS 9 Expected Credit Losses

Nature of the Key Audit Matter	Matters discussed with the Audit Committee
<p>This is a new and complex accounting standard which has required considerable judgement and interpretation in its implementation. These judgements have been key in the development of the new models which have been built and implemented to measure the expected credit losses on loans measured at amortised cost.</p> <p>There is a large number of data inputs required by these models. The data is from a number of systems that have not been used previously for the preparation of the accounting records. This increases the risk of completeness and accuracy of the data that has been used to create assumptions and is used to operate the models. In some cases, the lack of available data and quality of data has led to reasonable alternatives being sought to allow calculations to be performed.</p>	<p>Status updates were provided during the year due to the complexity and size of the implementation program. The Audit Committee reviewed the Global Public Policy Committee paper issued in July 2017 which promotes the high-quality audit of the accounting for expected credit losses. An assessment on the more judgemental interpretations made by management was shared with the Audit Committee. These included the determination of what constitutes a significant increase in credit risk for retail portfolios, the life of retail and wholesale revolving products and the judgements made in applying forward economic guidance to the impairment calculation.</p> <p>We highlighted significant post model adjustments that had been recorded to address challenges in data availability and quality or areas of model weakness.</p> <p>Perspectives were shared on the control environment over the disclosure of the impact of adopting HKFRS 9.</p>
How our audit addressed the Key Audit Matter	
<ul style="list-style-type: none"> • Controls over the selection and approval of the accounting policy were tested. This included our assessment of the compliance of the technical accounting papers prepared by management with the HKFRS 9 requirements for expected credit losses. • Controls over model governance and model development were tested. Our modelling specialists tested the modelling methodology for material portfolios. • Risk based testing of models, including independent validation of certain assumptions and model effectiveness tests, was performed. • Testing of the review controls performed by management to assess the reasonableness of the disclosed impact of adopting HKFRS 9 was performed. 	
Relevant references in the Annual Report and Accounts 2017	
<p>Note 1: Basis of preparation and significant accounting policies, page 51-52</p>	

The impact of HSBC's strategic actions

Nature of the Key Audit Matter	Matters discussed with the Audit Committee
<p>Auditing standards require that we consider the inherent risk of the potential for management override of controls. 2017 was the final year for HSBC Holdings plc ('HSBC') to achieve the outcomes set out in the strategic actions communicated to shareholders in June 2015. We considered whether this increased the incentive for management to over-ride controls given the external pressure to meet the targets. We assessed such plans inherently increase the incentive that controls may be overridden, and this inherent increase in incentive does not reflect other specific concern about the Bank or its management. Achievement of these strategic actions is not subject to audit. However, some of the key performance indicators used to track HSBC's performance are derived from the group's consolidated financial statements and our test plan was established to reflect the risk that the group's financial numbers may be misstated.</p>	<p>An initial view of the impact of the strategic actions was agreed with the Audit Committee during the planning stage of the audit. At that time we set out a test plan around financial numbers in the consolidated financial statements that were inherently subject to the risk of override. The initial view was re-assessed as certain key performance indicators became more sensitive to underlying changes in revenue and costs. Certain additional procedures relating to cost recognition were agreed with the Audit Committee.</p>
How our audit addressed the Key Audit Matter	
<ul style="list-style-type: none">• Reviewed and challenged changes to accounting policies, judgements and their application.• Performed additional substantive tests on journals, specifically considering cut off of revenue and expenses.• Tested the clearance of long outstanding reconciliation differences, such as those in intercompany reconciliations, including the appropriateness of the classification and reporting period.	
Relevant references in the Annual Report and Accounts 2017	
<p>Report of the Directors: Asia Strategy, page 3 Risk: Operational Risk, page 28</p>	

Other Information

The directors are responsible for the other information. The other information comprises the information included in the Financial Highlights, Report of Directors, Financial Review, Risk, Capital and Statement of Directors' Responsibilities sections of the *Annual Report and Accounts 2017*, but does not include the consolidated financial statements and our auditor's report thereon, which we obtained prior to the date of this auditor's report. The other information also includes the Banking Disclosure Statement 2017 and the list of the directors of the Bank's subsidiary undertakings (consolidated in the financial statements) during the period from 1 January 2017 to 20 February 2018, which are expected to be made available to us after the date of this auditor's report.

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

If, based on the work we have performed on the other information that we obtained prior to the date of this auditor's report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

When we read the Banking Disclosure Statement 2017 and the list of the directors of the Bank's subsidiary undertakings (consolidated in the financial statements) during the period from 1 January 2017 to 20 February 2018, if we conclude that there is a material misstatement therein, we are required to communicate the matter to the Audit Committee and take appropriate action considering our legal rights and obligations.

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

Responsibilities of Directors and the Audit Committee for the Consolidated Financial Statements

The directors are responsible for the preparation of the consolidated financial statements that give a true and fair view in accordance with HKFRSs issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the directors are responsible for assessing the group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the group or to cease operations, or have no realistic alternative but to do so.

The Audit Committee is responsible for overseeing the group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. We report our opinion solely to you, as a body, in accordance with section 405 of the Hong Kong Companies Ordinance and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with HKSAAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the Audit Committee, we determine those matters that were of most significance in the audit of the consolidated financial statements for the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is Mr. Mervyn Robert John Jacob.

PricewaterhouseCoopers

Certified Public Accountants

Hong Kong, 20 February 2018

Financial Statements

	Page
Consolidated income statement	46
Consolidated statement of comprehensive income	47
Consolidated balance sheet	48
Consolidated statement of cash flows	49
Consolidated statement of changes in equity	50

Notes on the Financial Statements

1	Basis of preparation and significant accounting policies	51
2	Operating profit	60
3	Insurance income	62
4	Employee compensation and benefits	62
5	Tax expense	65
6	Dividends	66
7	Trading assets	66
8	Derivatives	66
9	Financial assets designated at fair value	68
10	Loans and advances to customers	68
11	Impairment of loans and advances to customers	70
12	Financial investments	71
13	Assets pledged, assets transferred and collateral received	71
14	Investments in subsidiaries	72
15	Interests in associates and joint ventures	72
16	Goodwill and intangible assets	76
17	Property, plant and equipment	77

18	Prepayments, accrued income and other assets	77
19	Customer accounts	78
20	Trading liabilities	78
21	Financial liabilities designated at fair value	78
22	Debt securities in issue	78
23	Accruals and deferred income, other liabilities and provisions	78
24	Liabilities under insurance contracts	79
25	Subordinated liabilities	79
26	Preference shares	80
27	Share capital	80
28	Other equity instruments	80
29	Maturity analysis of assets and liabilities	81
30	Analysis of cash flows payable under financial liabilities by remaining contractual maturities	83
31	Contingent liabilities and commitments	84
32	Other commitments	84
33	Offsetting of financial assets and financial liabilities	85
34	Segmental analysis	85
35	Related party transactions	87
36	Fair values of financial instruments carried at fair value	89
37	Fair values of financial instruments not carried at fair value	91
38	Structured entities	92
39	Bank balance sheet and statement of changes in equity	94
40	Legal proceedings and regulatory matters	95
41	Ultimate holding company	97
42	Events after the balance sheet date	97
43	Approval of financial statements	97

Consolidated Financial Statements

Consolidated income statement

for the year ended 31 December

	Notes	2017 HK\$m	2016 HK\$m
Net interest income	2a	110,237	96,908
– interest income		138,081	122,564
– interest expense		(27,844)	(25,656)
Net fee income	2b	43,150	39,302
– fee income		52,312	47,139
– fee expense		(9,162)	(7,837)
Net trading income	2c	23,210	24,064
Net income from financial instruments designated at fair value	2d	15,380	3,570
Gains less losses from financial investments	2e	2,108	1,232
Dividend income		232	234
Net insurance premium income	3a	56,176	55,912
Other operating income	2f	4,740	11,516
Total operating income		255,233	232,738
Net insurance claims and benefits paid and movement in liabilities to policyholders	3b	(68,790)	(64,586)
Net operating income before loan impairment charges and other credit risk provisions		186,443	168,152
Loan impairment charges and other credit risk provisions	2g	(4,437)	(5,554)
Net operating income		182,006	162,598
Employee compensation and benefits	4a	(40,095)	(38,896)
General and administrative expenses	2h	(34,786)	(29,917)
Depreciation of property, plant and equipment	17	(4,650)	(4,493)
Amortisation and impairment of intangible assets		(1,536)	(1,497)
Total operating expenses		(81,067)	(74,803)
Operating profit		100,939	87,795
Share of profit in associates and joint ventures		14,680	14,912
Profit before tax		115,619	102,707
Tax expense	5	(19,601)	(17,912)
Profit for the year		96,018	84,795
Profit attributable to shareholders of the parent company		88,530	78,646
Profit attributable to non-controlling interests		7,488	6,149

Consolidated statement of comprehensive income

for the year ended 31 December

	2017 HK\$m	2016 HK\$m
Profit for the year	96,018	84,795
Other comprehensive income/(expense)		
Items that will be reclassified subsequently to the income statement when specific conditions are met:		
Available-for-sale investments:	1,609	499
– fair value gains/(losses)	3,346	(430)
– fair value gains reclassified to the income statement on disposal	(2,118)	(1,226)
– amounts reclassified to the income statement in respect of impairment losses	5	2
– fair value losses transferred to the income statement on hedged items	451	2,296
– income taxes	(75)	(143)
Cash flow hedges:	607	(802)
– fair value gains/(losses)	(6,780)	1,354
– fair value (gains)/losses reclassified to the income statement	7,506	(2,295)
– income taxes	(119)	139
Share of other comprehensive income/(expense) of associates and joint venture	(852)	1,266
Exchange differences	25,387	(15,241)
Items that will not be reclassified subsequently to the income statement:		
Changes in fair value of financial liabilities designated at fair value arising from changes in own credit risk ¹	(209)	–
– before income taxes	(250)	–
– income taxes	41	–
Property revaluation:	8,864	3,147
– fair value gains taken to equity	10,442	3,825
– income taxes	(1,578)	(678)
Remeasurement of defined benefit asset/liability:	1,371	833
– before income taxes	1,640	1,016
– income taxes	(269)	(183)
Other comprehensive income for the year, net of tax	36,777	(10,298)
Total comprehensive income for the year	132,795	74,497
Attributable to:		
– shareholders of the parent company	123,739	68,577
– non-controlling interests	9,056	5,920
Total comprehensive income for the year	132,795	74,497

¹ On 1 January 2017, the group adopted the requirements of Hong Kong Financial Reporting Standard ('HKFRS') 9 relating to the presentation of gains and losses on financial liabilities designated at fair value. As a result, the effect of changes in fair value of those liabilities arising from changes in own credit risk is presented in other comprehensive income. As permitted by the transitional requirements of HKFRS 9, comparatives have not been restated.

Consolidated Financial Statements

Consolidated balance sheet

at 31 December

	Notes	2017 HK\$m	2016 HK\$m
Assets			
Cash and sight balances at central banks		208,073	213,783
Items in the course of collection from other banks		25,714	21,401
Hong Kong Government certificates of indebtedness		267,174	242,194
Trading assets	7	496,434	371,634
Derivatives	8	300,243	479,807
Financial assets designated at fair value	9	122,646	106,016
Reverse repurchase agreements – non-trading		330,890	271,567
Placings with and advances to banks		433,005	463,211
Loans and advances to customers	10	3,328,980	2,834,114
Financial investments	12	1,720,873	1,835,351
Amounts due from Group companies	35	227,729	242,773
Interests in associates and joint ventures	15	144,717	125,792
Goodwill and intangible assets	16	59,865	56,936
Property, plant and equipment	17	116,336	111,640
Deferred tax assets	5	2,156	1,503
Prepayments, accrued income and other assets	18	158,511	171,230
Total assets		7,943,346	7,548,952
Liabilities			
Hong Kong currency notes in circulation		267,174	242,194
Items in the course of transmission to other banks		38,283	37,753
Repurchase agreements – non-trading		47,170	27,810
Deposits by banks		201,697	192,479
Customer accounts	19	5,138,272	4,900,004
Trading liabilities	20	231,365	188,470
Derivatives	8	309,353	462,458
Financial liabilities designated at fair value	21	49,278	51,116
Debt securities in issue	22	38,394	25,235
Retirement benefit liabilities	4c	2,222	3,867
Amounts due to Group companies	35	265,688	198,038
Accruals and deferred income, other liabilities and provisions	23	110,687	99,487
Liabilities under insurance contracts	24	438,017	386,170
Current tax liabilities	5	3,242	1,619
Deferred tax liabilities	5	24,391	21,401
Subordinated liabilities ¹	25	4,090	4,836
Preference shares	26	21,037	26,879
Total liabilities		7,190,360	6,869,816
Equity			
Share capital	27	151,360	114,359
Other equity instruments	28	14,737	14,737
Other reserves		123,417	85,886
Retained earnings		406,966	413,024
Total shareholders' equity		696,480	628,006
Non-controlling interests		56,506	51,130
Total equity		752,986	679,136
Total equity and liabilities		7,943,346	7,548,952

Consolidated statement of cash flows

for the year ended 31 December

(Re-presented)

	2017 HK\$m	2016 HK\$m
Profit before tax	115,619	102,707
Adjustments for non-cash items:		
Depreciation, amortisation and impairment	6,202	6,008
Net gain from investing activities	(3,564)	(1,211)
Share of profits in associates and joint ventures	(14,680)	(14,912)
(Gain)/loss on disposal of subsidiaries, businesses, associates and joint ventures	186	(1)
Loan impairment losses gross of recoveries and other credit risk provisions	5,330	6,712
Provisions	(618)	(7)
Share-based payment expense	970	1,019
Other non-cash items included in profit before tax	510	(6,313)
Elimination of exchange differences	(36,213)	7,450
Changes in operating assets and liabilities		
Change in net trading securities and derivatives	(55,262)	(70,563)
Change in loans and advances to banks and customers	(491,235)	(81,543)
Change in reverse repurchase agreements – non-trading	(75,091)	(15,267)
Change in financial assets designated at fair value	(16,630)	(7,991)
Change in other assets	144,752	(97,460)
Change in deposits by banks and customer accounts	247,486	304,113
Change in repurchase agreements – non-trading	19,360	11,652
Change in debt securities in issue	13,159	(15,624)
Change in financial liabilities designated at fair value	(1,838)	346
Change in other liabilities	63,627	117,955
Dividends received from associates	4,556	4,664
Contributions paid to defined benefit plans	(722)	(1,889)
Tax paid	(14,674)	(18,222)
Net cash from operating activities	(88,770)	231,623
Purchase of financial investments	(721,925)	(746,997)
Proceeds from the sale and maturity of financial investments	749,277	608,186
Purchase of property, plant and equipment	(2,997)	(3,009)
Proceeds from sale of property, plant and equipment and assets held for sale	5,572	2
Proceeds from disposal of customer loan portfolios	2,004	388
Net investment in intangible assets	(2,831)	(1,825)
Cash outflow on purchase of subsidiaries	(1,757)	–
Net cash from investing activities	27,343	(143,255)
Issue of ordinary share capital and other equity instruments	1,744	18,307
Redemption of preference shares and other equity instruments	(6,022)	(9,688)
Subordinated loan capital issued ¹	76,433	63,982
Subordinated loan capital repaid ¹	(18,737)	(3,110)
Dividends paid to shareholders of the parent company and non-controlling interests	(60,892)	(49,593)
Net cash from financing activities	(7,474)	19,898
Net increase/(decrease) in cash and cash equivalents	(68,901)	108,266
Cash and cash equivalents at 1 Jan	752,705	658,397
Exchange differences in respect of cash and cash equivalents	34,234	(13,958)
Cash and cash equivalents at 31 Dec	718,038	752,705
Cash and cash equivalents comprise: ²		
– cash and balances at central banks	208,073	213,783
– items in the course of collection from other banks	25,714	21,401
– loans and advances to banks of one month or less	293,499	311,734
– reverse repurchase agreements with banks of one month or less	152,104	167,872
– treasury bills, other bills and certificates of deposit less than three months	76,931	75,668
– less: items in the course of transmission to other banks	(38,283)	(37,753)

Interest received was HK\$136,539m (2016: HK\$123,812m), interest paid was HK\$28,324m (2016: HK\$27,403m) and dividends received were HK\$175m (2016: HK\$208m).

¹ Changes in subordinated liabilities (including those issued to group companies) during the year included amounts from issuance and repayments as presented above, and non-cash changes from foreign exchange gains (HK\$673m) and fair value gains (HK\$130m).

² The amount of cash and cash equivalents that are subject to exchange control and regulatory restrictions amounted to HK\$199,336m at 31 December 2017 (2016: HK\$182,494m).

In 2017, we enhanced the presentation of the consolidated statement of cash flows. As a result of this change, certificates of deposit with maturity of more than three months and financial investments held for backing liabilities to long-term policyholders are now presented as investing activities (previously presented as operating activities). Comparatives have been re-presented accordingly.

Consolidated statement of changes in equity

	Other reserves										
	Share capital	Other equity instruments	Retained earnings	Property revaluation reserve	Available-for-sale investment reserve	Cash flow hedge reserve	Foreign exchange reserve	Other ¹	Total shareholders' equity	Non-controlling interests	Total equity
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
At 1 Jan 2017	114,359	14,737	413,024	53,763	6,189	(793)	(31,861)	58,588	628,006	51,130	679,136
Profit for the year	–	–	88,530	–	–	–	–	–	88,530	7,488	96,018
Other comprehensive income/(expense) (net of tax)	–	–	976	8,144	636	596	24,913	(56)	35,209	1,568	36,777
– available-for-sale investments	–	–	–	–	1,422	–	–	–	1,422	187	1,609
– cash flow hedges	–	–	–	–	–	596	–	–	596	11	607
– changes in fair value of financial liabilities designated at fair value arising from changes in own credit risk ²	–	–	(207)	–	–	–	–	–	(207)	(2)	(209)
– property revaluation	–	–	–	8,144	–	–	–	–	8,144	720	8,864
– actuarial gains on defined benefit asset/liability	–	–	1,193	–	–	–	–	–	1,193	178	1,371
– share of other comprehensive expense of associates and joint ventures	–	–	(10)	–	(786)	–	–	(56)	(852)	–	(852)
– exchange differences	–	–	–	–	–	–	24,913	–	24,913	474	25,387
Total comprehensive income/(expense) for the year	–	–	89,506	8,144	636	596	24,913	(56)	123,739	9,056	132,795
Shares issued	1,744	–	–	–	–	–	–	–	1,744	–	1,744
Dividends paid ³	–	–	(56,260)	–	–	–	–	–	(56,260)	(4,632)	(60,892)
Movement in respect of share-based payment arrangements	–	–	(73)	–	–	–	–	(324)	(397)	(9)	(406)
Transfers and other movements ^{4,5,6}	35,257	–	(39,231)	(3,526)	–	–	–	7,148	(352)	961	609
At 31 Dec 2017	151,360	14,737	406,966	58,381	6,825	(197)	(6,948)	65,356	696,480	56,506	752,986
At 1 Jan 2016	96,052	14,737	380,381	52,099	4,880	(35)	(16,991)	53,078	584,201	51,685	635,886
Profit for the year	–	–	78,646	–	–	–	–	–	78,646	6,149	84,795
Other comprehensive income/(expense) (net of tax)	–	–	542	3,123	1,309	(758)	(14,870)	585	(10,069)	(229)	(10,298)
– available-for-sale investments	–	–	–	–	622	–	–	–	622	(123)	499
– cash flow hedges	–	–	–	–	–	(758)	–	–	(758)	(44)	(802)
– property revaluation	–	–	(245)	3,123	–	–	–	–	2,878	269	3,147
– actuarial gains on defined benefit asset/liability	–	–	793	–	–	–	–	–	793	40	833
– share of other comprehensive income/(expense) of associates and joint ventures	–	–	(6)	–	687	–	–	585	1,266	–	1,266
– exchange differences	–	–	–	–	–	–	(14,870)	–	(14,870)	(371)	(15,241)
Total comprehensive income/(expense) for the year	–	–	79,188	3,123	1,309	(758)	(14,870)	585	68,577	5,920	74,497
Shares issued	18,307	–	–	–	–	–	–	–	18,307	–	18,307
Dividends paid ³	–	–	(43,296)	–	–	–	–	–	(43,296)	(6,297)	(49,593)
Movement in respect of share-based payment arrangements	–	–	235	–	–	–	–	(258)	(23)	(3)	(26)
Transfers and other movements ⁵	–	–	(3,484)	(1,459)	–	–	–	5,183	240	(175)	65
At 31 Dec 2016	114,359	14,737	413,024	53,763	6,189	(793)	(31,861)	58,588	628,006	51,130	679,136

1 The other reserves mainly comprise share of associates' other reserves, purchase premium arising from transfer of business within the HSBC Group and the share-based payment reserve. The share-based payment reserve is used to record the amount relating to share awards and options granted to employees of the group directly by HSBC Holdings plc.

2 On 1 January 2017, the group adopted the requirements of Hong Kong Financial Reporting Standard ('HKFRS') 9 relating to the presentation of gains and losses on financial liabilities designated at fair value. As a result, the effect of changes in fair value of those liabilities arising from changes in own credit risk is presented in retained earnings. As permitted by the transitional requirements of HKFRS 9, comparatives have not been restated.

3 Including distributions paid on perpetual subordinated loans classified as equity under HKFRSs.

4 In 2017, the Bank redeemed US\$775m (HK\$6,022m) of preference shares which were classified as a financial liability in the consolidated balance sheet. The redemption was made by a payment out of distributable profits. The amount of preference shares has been credited to share capital with a corresponding adjustment to retained earnings in accordance with the capital maintenance requirements of the Companies Ordinance. In 2013, the Bank redeemed US\$3,745m (HK\$29,235m) of preference shares in the same manner. This amount was also credited to share capital with a corresponding adjustment to retained earnings in accordance with the capital maintenance requirements of the Companies Ordinance. The total amount credited to share capital with a corresponding adjustment to retained earnings in 2017 in respect of these transactions was HK\$35,257m. This amount is non-distributable.

5 The movement from retained earnings to other reserves includes the relevant transfers in associates according to local regulatory requirements.

6 The movement from property revaluation reserve to other reserves includes HK\$2,100m relating to transfer of properties to a fellow subsidiary as part of the Recovery & Resolution Plan as set out in the Report of the Directors on page 7-8.

Notes on the Consolidated Financial Statements

1 Basis of preparation and significant accounting policies

1.1 Basis of preparation

(a) Compliance with Hong Kong Financial Reporting Standards

The consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') have been prepared in accordance with Hong Kong Financial Reporting Standards ('HKFRSs') as issued by the Hong Kong Institute of Certified Public Accountants ('HKICPA') and accounting principles generally accepted in Hong Kong. These financial statements also comply with the requirements of the Hong Kong Companies Ordinance (Cap. 622) which are applicable to the preparation of financial statements.

Standards adopted during the year ended 31 December 2017

The group has adopted the requirements of HKFRS 9 'Financial Instruments' relating to the presentation of gains and losses on financial liabilities designated at fair value from 1 January 2017. As a result, the effect of changes in fair value of those liabilities arising from changes in own credit risk is presented in other comprehensive income with the remaining effect presented in profit or loss. As permitted by the transitional requirements of HKFRS 9, comparatives have not been restated. The adoption increased profit after tax by HK\$209m for the year ended 2017, with the opposite effect on other comprehensive income and no effect on net assets.

There were no other new standards applied in 2017. However, during 2017, the group adopted a number of amendments to standards which had an insignificant effect on the consolidated financial statements of the group.

(b) Future accounting developments

Minor amendments to HKFRSs

The group has not early applied any of the amendments effective after 31 December 2017, except the requirements of HKFRS 9 'Financial Instruments' relating to the presentation of gains and losses on financial liabilities designated at fair value, which was adopted from 1 January 2017.

Major new HKFRSs

The HKICPA has published HKFRS 9 'Financial Instruments', HKFRS 15 'Revenue from Contracts with Customers', HKFRS 16 'Leases' and HKFRS 17 'Insurance Contracts'.

HKFRS 9 'Financial Instruments'

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

Classification and measurement

The classification and measurement of financial assets will depend on how these are managed (i.e the entity's business model) and their contractual cash flow characteristics. These factors determine whether the financial assets are measured at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss ('FVPL'). The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in the population of financial assets measured at amortised cost or fair value compared with HKAS 39.

Impairment

The impairment requirements apply to financial assets measured at amortised cost and FVOCI, lease receivables and certain loan commitments and financial guarantee contracts. At initial recognition, an impairment allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12-month ECL'). In the event of a significant increase in credit risk, an allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL'). Financial assets where 12-month ECL is recognised are considered to be 'stage 1'; financial assets which are considered to have experienced a significant increase in credit risk are in 'stage 2'; and financial assets for which there is objective evidence of impairment so are considered to be in default or otherwise credit impaired are in 'stage 3'.

The assessment of credit risk and the estimation of ECL are required to be unbiased and probability-weighted, and should incorporate all available information which is relevant to the assessment including information about past events, current conditions and reasonable and supportable forecasts of economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under HKAS 39, and the resulting impairment charge will tend to be more volatile. HKFRS 9 will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with HKAS 39.

Hedge accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link with risk management strategy and permitting hedge accounting to be applied to a greater variety of hedging instruments and risks. However, they do not explicitly address macro hedge accounting strategies, which are particularly important for banks. As a result, HKFRS 9 includes an accounting policy choice to remain with HKAS 39 hedge accounting.

Notes on the Consolidated Financial Statements

Transitional impact

With the exception of the provisions relating to the presentation of gains and losses on financial liabilities designated at fair value, which were adopted from 1 January 2017, the requirements of HKFRS 9 'Financial Instruments' will be adopted from 1 January 2018. HKFRS 9 includes an accounting policy choice to continue with HKAS 39 hedge accounting, which the group has exercised, although it will implement the revised hedge accounting disclosures required by the related amendments to HKFRS 7 'Financial Instruments: Disclosures'. The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement to restate comparative periods. The group does not intend to restate comparatives.

The adoption of HKFRS 9 is expected to reduce net assets at 1 January 2018 by HK\$7,290m, with classification and measurement changes reducing net assets by HK\$4,674m, impairment reducing net assets by HK\$4,187m, and the resulting changes to deferred tax increasing net assets by HK\$1,571m. There is no material impact on the group's capital resources.

HKFRS 15 'Revenue from Contracts with Customers'

In July 2014, the HKICPA issued HKFRS 15 'Revenue from Contracts with Customers' and it is effective for annual periods beginning on or after 1 January 2018. HKFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognising revenue for performance obligations as they are satisfied. The group will adopt the standard on its mandatory effective date, and the standard will be applied on a retrospective basis, recognising the cumulative effect, if any, of initially applying the standard as an adjustment to the opening balance of retained earnings. The group has assessed the impact of HKFRS 15 and expects that the standard will have no significant effect, when applied, on the consolidated financial statements of the group.

HKFRS 16 'Leases'

In May 2016, the HKICPA issued HKFRS 16 'Leases' with an effective date of annual periods beginning on or after 1 January 2019. HKFRS 16 results in lessees accounting for most leases within the scope of the standard in a manner similar to the way in which finance leases are currently accounted for under HKAS 17 'Leases'. Lessees will recognise a 'right of use' asset and a corresponding financial liability on the balance sheet. The asset will be amortised over the length of the lease and the financial liability measured at amortised cost. Lessor accounting remains substantially the same as in HKAS 17. The group is currently assessing the impact of HKFRS 16 and it is not practicable to quantify the effect as at the date of the publication of these financial statements. Existing operating lease commitments are set out in note 32.

HKFRS 17 'Insurance contracts'

HKFRS 17 'Insurance contracts' was issued in January 2018, and sets out the requirements that an entity should apply in accounting for insurance contracts it issues and reinsurance contracts it holds. HKFRS 17 is effective from 1 January 2021, and the group is considering its impact.

(c) Foreign currencies

Items included in each of the group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The group's consolidated financial statements are presented in Hong Kong dollars.

Transactions in foreign currencies are recorded at the rate of exchange on the date of the transaction. Assets and liabilities denominated in foreign currencies are translated at the rate of exchange at the balance sheet date except non-monetary assets and liabilities measured at historical cost that are translated using the rate of exchange at the initial transaction date. Exchange differences are included in other comprehensive income or in the income statement depending on where the gain or loss on the underlying item is recognised.

In the consolidated financial statements, the assets, liabilities and results of foreign operations whose functional currency is not Hong Kong dollars are translated into the group's presentation currency at the reporting date. Exchange differences arising are recognised in other comprehensive income. On disposal of a foreign operation, exchange differences previously recognised in other comprehensive income are reclassified to the income statement.

(d) Presentation of information

Certain disclosures required by HKFRSs have been included in the audited sections of the *Annual Report and Accounts* as follows:

- Consolidated income statement and balance sheet data by global business are included in the 'Financial Review' on page 9.
- Disclosures concerning the nature and extent of risks relating to banking and insurance activities are included in the 'Risk' section on pages 14 to 28 and pages 30 to 33.
- Capital disclosures are included in the 'Capital' section on page 34.

In accordance with the group's policy to provide disclosures that help other stakeholders to understand the group's performance, financial position and changes thereto, the information provided in the Notes on the Financial Statements, the Risk section and the Capital section goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements. In addition, the group assesses good practice recommendations issued from time to time by relevant regulators and standard setters and will assess the applicability and relevance of such guidance, enhancing disclosures where appropriate.

(e) Critical accounting estimates and judgements

The preparation of financial information requires the use of estimates and judgements about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items highlighted as the critical accounting estimates and judgements in note 1.2 below, it is possible that the outcomes in the next financial year could differ from those on which management's estimates are based, resulting in materially different conclusions from those reached by management for the purposes of the 2017 Financial Statements. Management's selection of the group's accounting policies which contain critical estimates and judgements reflects the materiality of the items to which the policies are applied and the high degree of judgement and estimation uncertainty involved.

(f) Segmental analysis

The group's chief operating decision-maker is the Executive Committee which operates as a general management committee under the direct authority of the Board and operating segments are reported in a manner consistent with the internal reporting provided to the Executive Committee.

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

(g) Going concern

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

1.2 Summary of significant accounting policies

(a) Consolidation and related policies

Investments in subsidiaries

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

Business combinations are accounted for using the acquisition method. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. This election is made for each business combination.

The Bank's investments in subsidiaries are stated at cost less impairment losses.

Goodwill

Goodwill is allocated to cash-generating units for the purpose of impairment testing. Impairment testing is performed at least annually, or whenever there is an indication of impairment.

Interests in associates

The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint arrangements, as associates.

Investments in associates are recognised using the equity method. The attributable share of the results and reserves of associates are included in the consolidated financial statements of the group based on either financial statements made up to 31 December or pro-rated amounts adjusted for any material transactions or events occurring between the date of financial statements available and 31 December.

Investments in associates are assessed at each reporting date and tested for impairment when there is an indication that the investment may be impaired. Goodwill on acquisitions of interests in associates is not tested separately for impairment but is assessed as part of the carrying amount of the investment.

Critical accounting estimates and judgements

Impairment testing of investments in associates involves significant judgement in determining the value in use, and in particular estimating the present values of cash flows expected to arise from continuing to hold the investment. The most significant judgements relate to the impairment testing of our investment in Bank of Communications ('BoCom'). Key assumptions used in estimating BoCom's value in use, the sensitivity of the value in use calculation to different assumptions and a sensitivity analysis that shows the changes in key assumptions that would reduce the excess of value in use over the carrying amount (the 'headroom') to nil are described in note 15.

(b) Income and expenses

Operating income

Interest income and expense

Interest income and expense for all financial instruments, excluding 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 method. However, as an exception to this, interest on debt securities issued by the group that are designated under the fair value option and derivatives managed in conjunction with those debt securities are included in interest expense.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Non-interest income and expense

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is accounted for as follows:

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating a transaction, such as the acquisition of shares, for a third party); and
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management services).

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with the related interest income, expense and dividends.

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for listed equity securities, and usually the date when shareholders approve the dividend for unlisted equity securities.

Notes on the Consolidated Financial Statements

Net income from financial instruments designated at fair value includes all gains and losses from changes in the fair value of financial assets and liabilities designated at fair value through profit or loss, including derivatives that are managed in conjunction with those financial assets and liabilities, and liabilities under investment contracts. Interest income, interest expense and dividend income in respect of those financial instruments are also included, except for interest arising from debt securities issued by the group and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense'.

The accounting policies for insurance premium income are disclosed in note 1.2(f).

(c) Valuation of financial instruments

All financial instruments are initially recognised at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of a financial instrument on initial recognition is generally its transaction price (that is, the fair value of the consideration given or received). However, if there is a difference between the transaction price and the fair value of financial instruments whose fair value is based on a quoted price in an active market or a valuation technique that uses only data from observable markets, the group recognises the difference as a trading gain or loss at inception ('day 1 gain or loss'). In all other cases, the entire day 1 gain or loss is deferred and recognised in the income statement over the life of the transaction until the transaction matures or is closed out, the valuation inputs become observable or the group enters into an offsetting transaction.

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

Critical accounting estimates and judgements

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, where the measurement of fair value is more judgemental.

(d) Financial instruments measured at amortised cost

Loans and advances to banks and customers, held-to-maturity investments and most financial liabilities are measured at amortised cost. The carrying value of these financial assets at initial recognition includes any directly attributable transactions costs. If the initial fair value is lower than the cash amount advanced, such as for some leveraged finance and syndicated lending activities, the difference is deferred and recognised over the life of the loan (as described in paragraph (c) above) through the recognition of interest income, unless the loan becomes impaired.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time. When the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. When the group intends to hold the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss.

Impairment of loans and advances

Losses for impaired loans are recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Losses which may arise from future events are not recognised.

Individually assessed loans and advances

The factors considered in determining whether a loan is individually significant for the purposes of assessing impairment include the size of the loan, the number of loans in the portfolio, the importance of the individual loan relationship and how this is managed. Loans that are determined to be individually significant will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to justify treatment under a collective methodology.

Loans considered as individually significant are typically to corporate and commercial customers, are for larger amounts and are managed on an individual basis. For these loans, the group considers on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired.

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

Impairment losses are calculated by discounting the expected future cash flows of a loan, which include expected future receipts of contractual interest, at the loan's original effective interest rate or an approximation thereof, and comparing the resultant present value with the loan's current carrying amount.

Collectively assessed loans and advances

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

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for a collective impairment assessment. This assessment captures impairment losses that the group has incurred as a result of events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. When information becomes available which identifies losses on individual loans within a group, those loans are removed from the group and assessed individually.

Homogeneous groups of loans and advances

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

- When appropriate empirical information is available, the group utilises roll-rate methodology, which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of the loans that will eventually be written off as a result of the events occurring before the balance sheet date. Individual loans are grouped using ranges of past due days and statistical estimates are made of the likelihood that loans in each range will progress through the various stages of delinquency and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics; such as industry sector, loan grade or product. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring, for example through a missed payment, and its confirmation through write-off (known as the loss identification period). Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly-developed markets, models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a basic formulaic approach based on historical loss rate experience, or a discounted cash flow model. Where a basic formulaic approach is undertaken, the period between a loss event occurring and its identification is explicitly estimated by local management, and is typically between six and 12 months.

Write-off of loans and advances

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write-off may be earlier.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

Assets acquired in exchange for loans

When non-financial assets acquired in exchange for loans as part of an orderly realisation are held for sale, these assets are recorded as 'Assets held for sale' and reported in 'Accruals and deferred income, other liabilities and provisions'.

Renegotiated loans

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

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

Critical accounting estimates and judgements

Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date. Management is required to exercise judgement in making assumptions and estimates when calculating loan impairment allowances on both individually and collectively assessed loans and advances.

Collective impairment allowances are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis due to the large number of individually insignificant loans in the portfolio. The estimation methods include the use of statistical analyses of historical information, supplemented with significant management judgement, to assess whether current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than historical experience. Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographical concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations and other influences on customer payment patterns. Different factors are applied in different regions and countries to reflect local economic conditions, laws and regulations. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

For individually assessed loans, judgement is required in determining whether there is objective evidence that a loss event has occurred and, if so, the measurement of the impairment allowance. In determining whether there is objective evidence that a loss event has occurred, judgement is exercised in evaluating all relevant information on indicators of impairment, including the consideration of whether payments are contractually past-due and the consideration of other factors indicating deterioration in the financial condition and outlook of borrowers affecting their ability to pay.

A higher level of judgement is required for loans to borrowers showing signs of financial difficulty in market sectors experiencing economic stress, particularly where the likelihood of repayment is affected by the prospects for refinancing or the sale of a specified asset. For those loans where objective evidence of impairment exists, management determine the size of the allowance required based on a range of factors such as the realisable value of security, the likely dividend available on liquidation or bankruptcy, the viability of the customer's business model and the capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations.

The exercise of judgement requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency and there is no single factor to which our loan impairment allowances as a whole are sensitive.

Notes on the Consolidated Financial Statements

Non-trading reverse repurchase, repurchase and similar agreements

When debt securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to resell ('reverse repos') are not recognised on the balance sheet and an asset is recorded in respect of the initial consideration paid. Non-trading repos and reverse repos are measured at amortised cost. The difference between the sale and repurchase price or between the purchase and resale price is treated as interest and recognised in net interest income over the life of the agreement.

Contracts that are economically equivalent to reverse repurchase or repurchase agreements (such as sales or purchases of debt securities entered into together with total return swaps with the same counterparty) are accounted for similarly to, and presented together with, reverse repurchase or repurchase agreements.

(e) Financial instruments measured at fair value

Available-for-sale financial assets

Available-for-sale financial assets are recognised on the trade date when the group enters into contractual arrangements to purchase those instruments, and are normally derecognised when they are either sold or redeemed. They are subsequently remeasured at fair value, and changes therein are recognised in other comprehensive income until the assets are either sold or become impaired. Upon disposal, the cumulative gains or losses in other comprehensive income are recognised in the income statement as 'Gains less losses from financial investments'.

Impairment of available-for-sale financial assets

Available-for-sale financial assets are assessed at each balance sheet date for objective evidence of impairment. Impairment losses are recognised in the income statement within 'Loan impairment charges and other credit risk provisions' for debt instruments and within 'Gains less losses from financial investments' for equities.

Available-for-sale debt securities

In assessing objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in the recovery of future cash flows. A subsequent decline in the fair value of the instrument is recognised in the income statement when there is objective evidence of impairment as a result of decreases in the estimated future cash flows. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, or the instrument is no longer impaired, the impairment loss is reversed through the income statement.

Available-for-sale equity securities

A significant or prolonged decline in the fair value of the equity below its cost is objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the continuous period in which the fair value of the asset has been below its original cost at initial recognition.

All subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised in other comprehensive income. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement to the extent that further cumulative impairment losses have been incurred. Impairment losses recognised on the equity security are not reversed through the income statement.

Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated irrevocably at inception:

- the use of the designation removes or significantly reduces an accounting mismatch;
- when a group of financial assets, liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; and
- where financial instruments contain one or more non-closely related embedded derivatives.

Designated financial assets are recognised when the group enters into contracts with counterparties, which is generally on trade date, and are normally derecognised when the rights to the cash flows expire or are transferred. Designated financial liabilities are recognised when the group enters into contracts with counterparties, which is generally on settlement date, and are normally derecognised when extinguished. Subsequent changes in fair values are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

Under this criterion, the main classes of financial instruments designated by the group are:

Long-term debt issues

The interest and/or foreign exchange exposure on certain fixed rate debt securities issued has been matched with the interest and/or foreign exchange exposure on certain swaps as part of a documented risk management strategy.

Financial assets and financial liabilities under unit-linked and non-linked investment contracts

A contract under which the group does not accept significant insurance risk from another party is not classified as an insurance contract, other than investment contracts with discretionary participation features ('DPF'), but is accounted for as a financial liability. See note 1.2(f) for investment contracts with DPF and contracts where the group accepts significant insurance risk. Customer liabilities under linked and certain non-linked investment contracts issued by insurance subsidiaries and the corresponding financial assets are designated at fair value. Liabilities are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices. Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts. The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are deferred and amortised over the period during which the investment management services are provided.

Derivatives

Derivatives are financial instruments that derive their value from the price of underlying items such as equities, interest rates or other indices. Derivatives are recognised initially and are subsequently measured at fair value, with changes in fair value generally recorded in the income statement. Derivatives are classified as assets when their fair value is positive or as liabilities when their fair value is negative. This includes embedded derivatives which are bifurcated from the host contract when they meet the definition of a derivative on a stand-alone basis and are required by HKFRSs to be accounted for separately from the host contract.

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

Hedge accounting

When derivatives are held for risk management purposes they are designated in hedge relationships where the required criteria for documentation and hedge effectiveness are met. The group enters into fair value hedges, cash flow hedges or hedges of net investments in foreign operations as appropriate to the risk being hedged.

Fair value hedge

Changes in the fair value of derivatives are recorded in the income statement, along with changes in the fair value of the hedged assets or liabilities attributable to the hedged risk. If a hedge relationship no longer meets the criteria for hedge accounting, hedge accounting is discontinued; the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is recognised in the income statement immediately.

Cash flow hedge

The effective portion of gains and losses on hedging instruments is recognised in other comprehensive income; the ineffective portion of the change in fair value of hedging instruments that are part of a cash flow hedge relationship is recognised immediately in the income statement within 'Net trading income'. The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the same periods in which the hedged item affects profit or loss. In hedges of forecast transactions that result in recognition of a non-financial asset or liability, previous gains and losses recognised in other comprehensive income are included in the initial measurement of the asset or liability. When a hedge relationship is discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is immediately reclassified to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. The effective portion of gains and losses on the hedging instrument is recognised in other comprehensive income; other gains and losses are recognised immediately in the income statement. Gains and losses previously recognised in other comprehensive income are reclassified to the income statement on the disposal, or part disposal, of the foreign operation.

Derivatives that do not qualify for hedge accounting

Non-qualifying hedges are derivatives entered into as economic hedges of assets and liabilities for which hedge accounting was not applied.

(f) Insurance contracts

A contract is classified as an insurance contract where the group accepts significant insurance risk from another party by agreeing to compensate that party on the occurrence of a specified uncertain future event. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant. In addition, the group issues investment contracts with discretionary participation features ('DPF') which are also accounted for as insurance contracts as required by HKFRS 4 'Insurance Contracts'.

Net insurance premium income

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

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

Net insurance claims and benefits paid and movements in liabilities to policyholders

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

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

Liabilities under insurance contracts

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles. Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value, which is calculated by reference to the value of the relevant underlying funds or indices.

Notes on the Consolidated Financial Statements

Future profit participation on insurance contracts with DPF

Where contracts provide discretionary profit participation benefits to policyholders, liabilities for these contracts include provisions for the future discretionary benefits to policyholders. These provisions reflect the actual performance of the investment portfolio to date and management's expectation of the future performance of the assets backing the contracts, as well as other experience factors such as mortality, lapses and operational efficiency, where appropriate. This benefit may arise from the contractual terms, regulation, or past distribution policy.

Investment contracts with DPF

While investment contracts with DPF are financial instruments, they continue to be treated as insurance contracts as required by HKFRS 4. The group therefore recognises the premiums for those contracts as revenue and recognises as an expense the resulting increase in the carrying amount of the liability.

In the case of net unrealised investment gains on these contracts, whose discretionary benefits principally reflect the actual performance of the investment portfolio, the corresponding increase in the liabilities is recognised in either the income statement or other comprehensive income, following the treatment of the unrealised gains on the relevant assets. In the case of net unrealised losses, a deferred participating asset is recognised only to the extent that its recoverability is highly probable. Movements in the liabilities arising from realised gains and losses on relevant assets are recognised in the income statement.

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long-term investment contracts with DPF and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the equity holders' interest in the issuing insurance companies' profits expected to emerge from these contracts written at the balance sheet date. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in 'Other operating income' on a gross of tax basis.

Critical accounting estimates and judgements

The value of PVIF depends upon assumptions regarding future events. The PVIF is determined by discounting those expected future profits using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses, and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

(g) Property

Land and buildings

Land and buildings held for own use are carried at their revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses.

Revaluations are performed by professional qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value. Surpluses arising on revaluation are credited firstly to the income statement, to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same land and buildings, and are thereafter taken to the 'Property revaluation reserve'. Deficits arising on revaluation are first set off against any previous revaluation surpluses included in the 'Property revaluation reserve' in respect of the same land and buildings, and are thereafter recognised in the income statement.

Buildings held for own use which are situated on leasehold land where it is possible to reliably separate the value of the building from the value of the leasehold land at inception of the lease are revalued by professional qualified valuers, on a depreciated replacement cost basis or surrender value, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value.

Leasehold land and buildings are depreciated over the shorter of the unexpired terms of the leases or the remaining useful lives.

The Government of Hong Kong owns all the land in Hong Kong and permits its use under leasehold arrangements. Similar arrangements exist in mainland China. At inception of the lease, where the cost of land is known or can be reliably determined and the term of the lease is not less than 50 years, the group records its interests in leasehold land and land use rights as land and buildings held for own use. Where the term is less than 50 years, the group records its interests as operating leases.

Where the cost of the land is unknown or cannot be reliably determined, and the leasehold land and land use rights are not clearly held under an operating lease, they are accounted for as land and buildings held for own use.

Investment properties

The group holds certain properties as investments to earn rentals or for capital appreciation, or both, and those investment properties are included on balance sheet at fair value with changes in fair value being recognised in the income statement.

(h) Employee compensation and benefits

Post-employment benefit plans

The group operates a number of pension schemes (including defined benefit and defined contribution) and post-employment benefit schemes.

Payments to defined contribution plans are charged as an expense as the employees render service.

Defined benefit pension obligations are calculated using the projected unit credit method. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit asset or liability and is presented in operating expenses.

Re-measurements of the net defined benefit asset or liability, which comprise actuarial gains and losses, return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in other comprehensive income. The net defined benefit asset or liability represents the present value of defined benefit obligations reduced by the fair value of plan assets after applying the asset ceiling test where the net defined benefit surplus is limited to the present value of available refunds and reductions in future contributions to the plan.

(i) Tax

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

Current tax is the tax expected to be payable on the taxable profit for the year and any adjustment to tax payable in respect of previous years. The group provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled.

Current and deferred tax is calculated based on tax rates and laws enacted, or substantively enacted, by the balance sheet date.

(j) Provisions, contingent liabilities and guarantees

Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a present legal or constructive obligation which has arisen as a result of past events and for which a reliable estimate can be made.

Critical accounting estimates and judgements

Provisions

Judgement is involved in determining whether a present obligation exists and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on the assessment of litigation, property (including onerous contracts) and similar obligations. Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When matters are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists, and estimating the probability and amount of any outflows that may arise. As matters progress, management and legal advisers evaluate on an ongoing basis whether provisions should be recognised, revising previous judgements and estimates as appropriate. At more advanced stages, it is typically easier to make judgements and estimates around a better defined set of possible outcomes. However, the amount provisioned can remain very sensitive to the assumptions used. There could be a wide range of possible outcomes for any pending legal proceedings, investigations or inquiries. As a result, it is often not practicable to quantify a range of possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved.

Contingent liabilities, contractual commitments and guarantees

Contingent liabilities

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security and contingent liabilities related to legal proceedings or regulatory matters, are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

Financial guarantee contracts

Liabilities under financial guarantee contracts which are not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or present value of the fee receivable.

The Bank has issued financial guarantees and similar contracts to other group entities. The group elects to account for certain guarantees as insurance contracts in the Bank financial statements, in which case they are measured and recognised as insurance liabilities. This election is made on a contract by contract basis, and is irrevocable.

Notes on the Consolidated Financial Statements

2 Operating profit

(a) Net interest income

Within net interest income, there is an amount of HK\$277m (2016: HK\$374m) interest income recognised on impaired financial assets in the year.

(b) Net fee income

	2017	2016
	HK\$m	HK\$m
Account services	2,863	3,063
Funds under management	7,000	5,771
Cards	7,622	7,063
Credit facilities	2,886	2,825
Broking income	4,386	3,131
Imports/exports	3,627	3,771
Unit trusts	6,987	5,855
Underwriting	1,477	1,188
Remittances	3,316	3,324
Global custody	3,626	3,450
Insurance agency commission	1,982	1,746
Other	6,540	5,952
Fee income	52,312	47,139
Fee expense	(9,162)	(7,837)
	43,150	39,302

Net fee income includes

	2017	2016
	HK\$m	HK\$m
Net fee income includes the following:		
Net fee income, other than amounts included in determining the effective interest rate, arising from financial assets or financial liabilities that are not held for trading or designated at fair value	11,031	11,602
– fee income	15,443	14,892
– fee expense	(4,412)	(3,290)
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	8,904	7,706
– fee income	9,843	8,551
– fee expense	(939)	(845)

(c) Net trading income

	2017	2016
	HK\$m	HK\$m
Dealing profits	15,847	18,195
Net interest income on trading activities	4,194	3,718
Dividend income from trading securities	3,146	2,074
Gains from hedging activities	23	77
Fair value hedges		
– net loss on hedged items attributable to the hedged risk	(850)	(2,550)
– net gain on hedging instruments	835	2,598
Cash flow hedges		
– net hedging gain	38	29
	23,210	24,064

(d) Net income from financial instruments designated at fair value

	2017	2016
	HK\$m	HK\$m
Income on assets designated at fair value which back insurance and investment contracts	18,162	4,104
Increase in fair value of liabilities to customers under investment contracts	(2,555)	(651)
	15,607	3,453
Net change in fair value of other financial assets/liabilities designated at fair value ¹	(242)	102
Interest income on financial assets and liabilities designated at fair value	15	15
	15,380	3,570

¹ On 1 January 2017, the group adopted the requirements of Hong Kong Financial Reporting Standard ('HKFRS') 9 relating to the presentation of gains and losses on financial liabilities designated at fair value. As a result, the effect of changes in fair value of those liabilities arising from changes in own credit risk is presented in other comprehensive income and taken to retained earnings. In 2016, the group recognised a HK\$62m gain from changes in the fair value of the group's issued debt securities arising from changes in own credit risk.

(e) Gains less losses from financial investments

	2017	2016
	HK\$m	HK\$m
Gains on disposal of available-for-sale securities	2,113	1,234
Impairment of available-for-sale equity investments	(5)	(2)
	2,108	1,232

There were no gains or losses on the disposal of held-to-maturity investments in the year (2016: nil).

(f) Other operating income

	2017	2016
	HK\$m	HK\$m
Movement in present value of in-force insurance business	305	7,306
Gains on investment properties	416	36
Gains/(losses) on disposal of property, plant and equipment and assets held for sale	77	(57)
Gains/(losses) on disposal of subsidiaries, associates and business portfolios	(186)	1
Rental income from investment properties	426	400
Other	3,702	3,830
	4,740	11,516

Other included net losses on loans and receivables of HK\$75m (2016: gain of HK\$146m). There were no gains or losses on disposal of financial liabilities measured at amortised cost in the year (2016: nil).

(g) Loan impairment charges and other credit risk provisions

	2017	2016
	HK\$m	HK\$m
Individually assessed impairment charges:	2,194	3,380
– new charges	4,239	5,224
– releases	(1,865)	(1,567)
– recoveries	(180)	(277)
Collectively assessed impairment charges	2,136	2,065
Other credit risk provisions	107	109
	4,437	5,554

There were no impairment charges against available-for-sale debt securities and held-to-maturity investments in the year (2016: nil).

(h) General and administrative expenses

	2017	2016
	HK\$m	HK\$m
Premises and equipment	7,814	7,772
– rental expenses	3,717	3,665
– other premises and equipment expenses	4,097	4,107
Marketing and advertising expenses	2,785	2,909
Other administrative expenses	24,187	19,236
	34,786	29,917

Included in operating expenses were direct operating expenses of HK\$32m (2016: HK\$27m) arising from investment properties that generated rental income in the year. Direct operating expenses arising from investment properties that did not generate rental income amounted to HK\$4m (2016: HK\$4m).

Included in operating expenses were minimum lease payments under operating leases of HK\$3,598m (2016: HK\$3,675m).

(i) Auditors' remuneration

Auditors' remuneration amounted to HK\$122m (2016: HK\$82m).

3 Insurance Income

(a) Net insurance premium income

	Non-linked insurance HK\$m	Linked insurance HK\$m	Total HK\$m
2017			
Gross insurance premium income	61,577	1,669	63,246
Reinsurers' share of gross insurance premium income	(7,052)	(18)	(7,070)
	54,525	1,651	56,176
2016			
Gross insurance premium income	57,349	2,522	59,871
Reinsurers' share of gross insurance premium income	(3,930)	(29)	(3,959)
	53,419	2,493	55,912

(b) Net insurance claims and benefits paid and movement in liabilities to policyholders

	Non-linked insurance HK\$m	Linked insurance HK\$m	Total HK\$m
2017			
Gross claims and benefits paid and movement in liabilities to policyholders	65,671	8,841	74,512
Claims, benefits and surrenders paid	19,765	7,239	27,004
Movement in liabilities	45,906	1,602	47,508
Reinsurers' share of claims and benefits paid and movement in liabilities	(6,894)	1,172	(5,722)
Reinsurers' share of claims, benefits and surrenders paid	(1,727)	(1,715)	(3,442)
Reinsurers' share of movement in liabilities	(5,167)	2,887	(2,280)
	58,777	10,013	68,790
2016			
Gross claims and benefits paid and movement in liabilities to policyholders	63,473	4,472	67,945
Claims, benefits and surrenders paid	19,099	2,395	21,494
Movement in liabilities	44,374	2,077	46,451
Reinsurers' share of claims and benefits paid and movement in liabilities	(3,514)	155	(3,359)
Reinsurers' share of claims, benefits and surrenders paid	(319)	(80)	(399)
Reinsurers' share of movement in liabilities	(3,195)	235	(2,960)
	59,959	4,627	64,586

4 Employee compensation and benefits

(a) Employee compensation and benefits

	2017 HK\$m	2016 HK\$m
Wages and salaries	36,485	35,376
Social security costs	1,110	1,022
Retirement benefit costs	2,500	2,498
– defined contribution plans	1,685	1,505
– defined benefit plans	815	993
	40,095	38,896

'Wages and salaries' include the effect of share-based payments arrangements as follows:

	2017 HK\$m	2016 HK\$m
Restricted share awards	944	985
Savings-related shares and other share option plans	108	107
	1,052	1,092

(b) Directors' emoluments

The aggregate emoluments of the Directors of the Bank disclosed pursuant to section 4 of the Companies (Disclosure of Information about Benefits of Directors) Regulation were HK\$111m (2016: HK\$102m). This comprises fees of HK\$9m (2016: HK\$9m) and other emoluments of HK\$102m (2016: HK\$93m) which includes contributions to pension schemes of HK\$1m (2016: HK\$1m). Non-cash benefits which are included in other emoluments mainly relate to share-based payment awards, and the provision of housing and furnishing. Details on loans to directors are set out in note 35.

(c) Retirement benefit pension plans

The group operates a number of retirement benefit plans, with a total cost of HK\$2,500m (2016: HK\$2,498m), the largest of which is the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme ('the Principal Plan').

In Hong Kong, the Principal Plan covers employees of the Bank and certain other local employees of the Group. The Principal Plan comprises a funded defined benefit scheme (which provides a lump sum on retirement but is now closed to new members) and a defined contribution scheme. The latter was established on 1 January 1999 for new employees, and the group has been moving to defined contribution plans for all new employees. Since the defined benefit element of the Principal Plan is a final salary lump sum scheme, its exposure to longevity risk and interest rate risk is limited.

The trustee assumes the overall responsibility for the Principal Plan but a management committee and a number of sub-committees have also been established. These committees have been established to broaden the governance and manage the concomitant issues.

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

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

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

	2017	2016
	HK\$m	HK\$m
At 1 January	(7,287)	(8,303)
Actuarial gains recognised in other comprehensive income	1,640	1,016
At 31 December	(5,647)	(7,287)

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

Net defined benefit liability

	Fair value of plan assets	Present value of defined benefit obligations	Net defined benefit liability
	HK\$m	HK\$m	HK\$m
At 1 Jan 2017	14,755	(18,552)	(3,797)
Service cost	–	(722)	(722)
Current service cost	–	(748)	(748)
Past service cost and gains from settlements ¹	–	26	26
Net interest expense on the net defined benefit liability	281	(362)	(81)
Remeasurement effects recognised in other comprehensive income	1,633	7	1,640
– return on plan assets (excluding interest income)	1,633	–	1,633
– actuarial gains	–	7	7
Exchange differences and other movements ²	(450)	482	32
Contributions by the group	722	–	722
Benefits paid	(1,774)	1,839	65
At 31 Dec 2017	15,167	(17,308)	(2,141)
Retirement benefit liabilities recognised on the balance sheet			(2,222)
Retirement benefit assets recognised on the balance sheet (within 'Prepayment, accrued income and other assets')			81
Present value of defined benefit obligation relating to:			
– actives		(17,044)	
– pensioners		(264)	

Notes on the Consolidated Financial Statements

Net defined benefit liability (continued)

	Fair value of plan assets	Present value of defined benefit obligations	Net defined benefit liability
	HK\$m	HK\$m	HK\$m
At 1 Jan 2016	13,974	(19,736)	(5,762)
Service cost	–	(878)	(878)
Current service cost	–	(846)	(846)
Past service cost and losses from settlements ¹	–	(32)	(32)
Net interest income/(expense) on the net defined benefit liability	303	(415)	(112)
Remeasurement effects recognised in other comprehensive income	91	925	1,016
– return on plan assets (excluding interest income)	91	–	91
– actuarial gains	–	925	925
Exchange differences and other movements	(19)	28	9
Contributions by the group	1,889	–	1,889
Benefits paid	(1,483)	1,524	41
At 31 Dec 2016	14,755	(18,552)	(3,797)
Retirement benefit liabilities recognised on the balance sheet			(3,867)
Retirement benefit assets recognised on the balance sheet (within 'Prepayment, accrued income and other assets')			70
Present value of defined benefit obligation relating to:			
– actives		(18,300)	
– pensioners		(252)	

¹ Gains/(losses) from settlements arise as the difference between assets distributed and liabilities extinguished on settlements.

² Other movements in 2017 included the impact from transfer of certain employees to a fellow subsidiary.

The group expects to make HK\$740m of contributions to defined benefit pension plans during 2018.

(iii) Fair value of plan assets by asset classes

	2017			2016		
	Value	Quoted market price in active market	Thereof HSBC	Value	Quoted market price in active market	Thereof HSBC
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Fair value of plan assets	15,167	15,167	321	14,755	14,755	1,348
– equities	4,791	4,791	–	5,260	5,260	–
– bonds	9,539	9,539	–	7,358	7,358	–
– other ¹	837	837	321	2,137	2,137	1,348

¹ Other mainly consists of cash and deposits.

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

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

	2018	2019	2020	2021	2022	2023-2027
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
HSBC Group Hong Kong Local Staff Retirement Benefit Scheme	559	861	980	1,093	1,049	3,854

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

The present value of the Principal Plan's obligation was HK\$10,086m (2016: HK\$11,215m). The principal actuarial assumptions used to calculate the group's obligations for the Principal Plan for the year, and used as the basis for measuring the expenses in relation to the Principal Plan, were as follows:

	2017	2016
	% p.a.	% p.a.
Discount rate	1.70	1.80
Rate of pay increase	3.0	3.0
Mortality table	HKLT2016 ¹	HKLT2015

¹ HKLT2016- Hong Kong Life Tables 2016.

The group determines the discount rates to be applied to its obligations in consultation with the Principal Plan's local actuary, on the basis of current average yields of Hong Kong Government bonds and Hong Kong Exchange Fund Notes, with maturities consistent with those of the defined benefit obligations.

(vi) Actuarial assumption sensitivities

The discount rate and rate of pay increase are sensitive to changes in market conditions arising during the reporting period. The following table shows the financial impact of assumption changes on the Principal Plan at year end:

	2017 HK\$m	2016 HK\$m
Impact on Pension Obligation:		
Discount rate		
– increase of 25bps	(183)	(215)
– decrease of 25bps	189	222
Rate of pay increase		
– increase of 25bps	193	227
– decrease of 25bps	(188)	(221)

5 Tax expense

The Bank and its subsidiaries in Hong Kong have provided for Hong Kong profits tax at the rate of 16.5% (2016: 16.5%) on the profits for the year assessable in Hong Kong. Overseas branches and subsidiaries have similarly provided for tax in the countries in which they operate at the appropriate rates of tax ruling in 2017. Deferred taxation is provided for in accordance with the group's accounting policy in note 1.2(i).

The charge for taxation in the income statement comprises:

	2017 HK\$m	2016 HK\$m
Current tax	18,801	15,754
– Hong Kong taxation – on current year profit	10,489	8,567
– Hong Kong taxation – adjustments in respect of prior years	(3)	(74)
– overseas taxation – on current year profit	8,588	7,598
– overseas taxation – adjustments in respect of prior years	(273)	(337)
Deferred tax	800	2,158
– origination and reversal of temporary differences	805	2,159
– effect of changes in tax rates	3	13
– adjustments in respect of prior years	(8)	(14)
	19,601	17,912

Reconciliation between taxation charge and accounting profit at applicable tax rates

	2017 HK\$m	2016 HK\$m
Profit before tax	115,619	102,707
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	21,915	19,727
Effects of profits in associates and joint ventures	(2,333)	(2,390)
Non-taxable income and gains	(2,623)	(1,951)
Local taxes and overseas withholding taxes	810	1,275
Permanent disallowables	1,001	957
Others	831	294
Tax expense	19,601	17,912

Movements of deferred tax assets and liabilities

	Accelerated capital allowances HK\$m	Insurance technical provisions HK\$m	Expense provisions HK\$m	Impairment allowances on financial assets HK\$m	Revaluation of properties HK\$m	Other HK\$m	Total HK\$m
2017							
Assets	108	–	961	674	–	2,415	4,158
Liabilities	(626)	(7,323)	–	–	(12,768)	(3,339)	(24,056)
At 1 Jan	(518)	(7,323)	961	674	(12,768)	(924)	(19,898)
Exchange and other adjustments	9	(44)	84	18	396	(15)	448
Income statement	(149)	(50)	251	(201)	283	(934)	(800)
Equity	–	–	–	–	(1,578)	(408)	(1,986)
At 31 Dec	(658)	(7,417)	1,296	491	(13,667)	(2,281)	(22,236)
Assets ¹	93	–	1,296	491	–	2,154	4,034
Liabilities ¹	(751)	(7,417)	–	–	(13,667)	(4,435)	(26,270)

Notes on the Consolidated Financial Statements

	Accelerated capital allowances HK\$m	Insurance technical provisions HK\$m	Expense provisions HK\$m	Impairment allowances on financial assets HK\$m	Revaluation of properties HK\$m	Other HK\$m	Total HK\$m
2016							
Assets ¹	132	–	983	1,107	–	718	2,940
Liabilities ¹	(643)	(6,134)	–	(249)	(12,503)	(374)	(19,903)
At 1 Jan	(511)	(6,134)	983	858	(12,503)	344	(16,963)
Exchange and other adjustments	(2)	24	(274)	6	125	198	77
Charge/(credit) to income statement	(5)	(1,213)	252	(190)	288	(1,290)	(2,158)
Charge/(credit) to reserves	–	–	–	–	(678)	(176)	(854)
At 31 Dec	(518)	(7,323)	961	674	(12,768)	(924)	(19,898)
Assets ¹	108	–	961	674	–	2,415	4,158
Liabilities ¹	(626)	(7,323)	–	–	(12,768)	(3,339)	(24,056)

¹ After netting off balances within countries, the balances as disclosed in the accounts are as follows: deferred tax assets HK\$2,156m (2016: HK\$ 1,503m); and deferred tax liabilities HK\$24,391m (2016: HK\$21,401m).

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK\$2,572m (2016: HK\$2,497m). Of this amount, HK\$1,898m (2016: HK\$2,047m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK\$2,321m (2016: HK\$1,334m) has been provided in respect of distributable reserves or post-acquisition reserves of associates that, on distribution or sale, would attract withholding tax.

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

6 Dividends

Dividends to ordinary shareholders of the parent company

	2017		2016	
	HK\$ per share	HK\$m	HK\$ per share	HK\$m
Ordinary dividends paid				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	0.56	25,438	0.44	17,065
– first interim dividend paid	0.22	10,000	0.20	8,500
– second interim dividend paid	0.22	10,000	0.19	8,500
– third interim dividend paid	0.22	10,000	0.19	8,500
Total	1.22	55,438	1.02	42,565

The Directors have declared a fourth interim dividend in respect of the financial year ended 31 December 2017 of HK\$0.36 per ordinary share (HK\$16,559m) (2016: HK\$0.56 per ordinary share (HK\$25,438m)).

Distributions on other equity instruments

	2017 HK\$m	2016 HK\$m
US\$1,900m floating rate perpetual subordinated loans (interest rate at one year US dollar LIBOR plus 3.84%)	822	731

7 Trading assets

	2017 HK\$m	2016 HK\$m
Treasury and other eligible bills	100,566	91,908
Debt securities	250,730	180,501
Equity shares	107,301	71,915
Other ¹	37,837	27,310
At 31 Dec	496,434	371,634

¹ 'Other' trading assets primarily include settlement accounts with banks and customers.

8 Derivatives

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio risk arising from client business, and to manage and hedge the group's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments) are held for trading. Within the held for trading classification are two types of derivative instruments: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels. When entering into derivative transactions, the group employs the same credit risk management framework to assess and approve potential credit exposures that it uses for traditional lending.

Fair values of derivatives by product type

	Fair value – Assets				Fair value – Liabilities			
	Trading	Cash flow hedges	Fair value hedges	Total	Trading	Cash flow hedges	Fair value hedges	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Foreign Exchange	198,483	2,449	–	200,932	201,829	3,575	–	205,404
Interest rate	145,569	62	2,369	148,000	147,460	70	632	148,162
Equity	22,116	–	–	22,116	25,106	–	–	25,106
Credit	5,591	–	–	5,591	5,970	–	–	5,970
Commodity and other	1,228	–	–	1,228	2,335	–	–	2,335
Gross total	372,987	2,511	2,369	377,867	382,700	3,645	632	386,977
Offset				(77,624)				(77,624)
At 31 Dec 2017				300,243				309,353
Foreign Exchange	363,707	6,570	–	370,277	350,787	1,322	–	352,109
Interest rate	150,263	22	2,534	152,819	150,590	247	813	151,650
Equity	22,350	–	–	22,350	24,653	–	–	24,653
Credit	2,431	–	–	2,431	2,437	–	–	2,437
Commodity and other	4,529	–	–	4,529	4,208	–	–	4,208
Gross total	543,280	6,592	2,534	552,406	532,675	1,569	813	535,057
Offset				(72,599)				(72,599)
At 31 Dec 2016				479,807				462,458

Notional contract amounts of derivatives by product type

	Trading	Cash flow hedges	Fair value hedges	Total
	HK\$m	HK\$m	HK\$m	HK\$m
Foreign Exchange	18,928,664	132,198	–	19,060,862
Interest rate	26,655,864	29,109	268,927	26,953,900
Equity	762,895	–	–	762,895
Credit	659,200	–	–	659,200
Commodity and other	82,181	–	–	82,181
At 31 Dec 2017	47,088,804	161,307	268,927	47,519,038
Foreign Exchange	18,076,732	140,665	–	18,217,397
Interest rate	18,871,195	46,049	262,940	19,180,184
Equity	604,504	–	–	604,504
Credit	474,160	–	–	474,160
Commodity and other	140,339	–	–	140,339
At 31 Dec 2016	38,166,930	186,714	262,940	38,616,584

Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities include market-making and risk management.

Hedging derivatives

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

The accounting treatment of hedging transactions varies according to the nature of the instrument hedged and the type of hedging transaction. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or hedges of net investments in foreign operations.

(a) Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates.

Notes on the Consolidated Financial Statements

(b) Cash flow hedges

The group's cash flow hedges consist principally of interest rate and currency swaps that are used to protect against exposures to variability in future interest and principal cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions.

Amount transferred to the income statement in respect of cash flow hedges included a gain of HK\$1,834m (2016: HK\$2,286m gain) taken to 'Net interest income' and a loss of HK\$8,602m (2016: HK\$341m loss) taken to 'Net trading income'. The group does not have any qualifying cash flow hedges that involve non-financial assets or non-financial liabilities (2016: none).

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the year to 31 December 2017, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2016: insignificant amount).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2017 is as follows:

	3 months or less HK\$m	More than 3 months but less than 1 year HK\$m	5 years or less but more than 1 year HK\$m	More than 5 years HK\$m
At 31 Dec 2017				
Cash inflows from assets	84,212	117,592	57,189	321
Cash outflows from liabilities	(6,251)	(6,171)	(6,171)	—
Net cash inflows	77,961	111,421	51,018	321
At 31 Dec 2016				
Cash inflows from assets	92,356	135,219	82,205	—
Cash outflows from liabilities	(6,329)	(6,329)	(5,695)	—
Net cash inflows	86,027	128,890	76,510	—

Derivatives valued using models with unobservable inputs

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

The aggregate unobservable inception profit yet to be recognised in the income statement is immaterial.

9 Financial assets designated at fair value

	2017 HK\$m	2016 HK\$m
Treasury and other eligible bills	514	418
Debt securities	18,142	17,435
Equity shares	103,990	88,163
At 31 Dec	122,646	106,016

10 Loans and advances to customers

	2017 HK\$m	2016 HK\$m
Gross loans and advances to customers	3,342,025	2,846,806
Impairment allowances	(13,045)	(12,692)
At 31 Dec	3,328,980	2,834,114

The following analysis of loans and advances to customers is based on the categories used by the HSBC Group.

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

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
At 31 Dec 2017			
Residential mortgages ¹	549,247	306,541	855,788
Credit card advances	61,672	27,696	89,368
Other personal	156,121	73,998	230,119
Total personal	767,040	408,235	1,175,275
Commercial, industrial and international trade	488,705	422,672	911,377
Commercial real estate	245,279	69,247	314,526
Other property-related lending	275,744	85,036	360,780
Government	39,558	5,509	45,067
Other commercial	171,438	157,939	329,377
Total corporate and commercial	1,220,724	740,403	1,961,127
Non-bank financial institutions	116,915	84,917	201,832
Settlement accounts	3,021	770	3,791
Total financial	119,936	85,687	205,623
Gross loans and advances to customers	2,107,700	1,234,325	3,342,025
Individually assessed impairment allowances	(3,429)	(4,800)	(8,229)
Collectively assessed impairment allowances	(2,240)	(2,576)	(4,816)
Net loans and advances to customers	2,102,031	1,226,949	3,328,980
At 31 Dec 2016			
Residential mortgages ¹	492,989	267,619	760,608
Credit card advances	58,289	22,665	80,954
Other personal	132,171	70,947	203,118
Total personal	683,449	361,231	1,044,680
Commercial, industrial and international trade	428,035	384,227	812,262
Commercial real estate	198,579	55,786	254,365
Other property-related lending	221,919	69,911	291,830
Government	20,230	2,405	22,635
Other commercial	136,729	132,944	269,673
Total corporate and commercial	1,005,492	645,273	1,650,765
Non-bank financial institutions	103,311	45,611	148,922
Settlement accounts	1,337	1,102	2,439
Total financial	104,648	46,713	151,361
Gross loans and advances to customers	1,793,589	1,053,217	2,846,806
Individually assessed impairment allowances	(2,960)	(5,099)	(8,059)
Collectively assessed impairment allowances	(1,959)	(2,674)	(4,633)
Net loans and advances to customers	1,788,670	1,045,444	2,834,114

¹ Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK\$36,976m (2016: HK\$30,215m).

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

Loans and advances to customers include equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases

	2017			2016		
	Present value of the minimum lease payments	Unearned future finance income	Total minimum lease payments	Present value of the minimum lease payments	Unearned future finance income	Total minimum lease payments
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Amounts receivable						
– within one year	1,968	584	2,552	2,151	677	2,828
– after one year but within five years	6,582	1,922	8,504	7,764	1,951	9,715
– after five years	19,229	3,594	22,823	18,296	3,346	21,642
	27,779	6,100	33,879	28,211	5,974	34,185
Impairment allowances	(82)			(28)		
Net investment in finance leases and hire purchase contracts	27,697			28,183		

Notes on the Consolidated Financial Statements

11 Impairment of loans and advances to customers

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

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

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
At 31 Dec 2017			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	6,284	9,259	15,543
Collectively assessed	2,101,416	1,225,066	3,326,482
– impaired loans and advances	673	1,363	2,036
– non-impaired loans and advances	2,100,743	1,223,703	3,324,446
Total gross loans and advances to customers	2,107,700	1,234,325	3,342,025
Impairment allowances	(5,669)	(7,376)	(13,045)
– individually assessed	(3,429)	(4,800)	(8,229)
– collectively assessed	(2,240)	(2,576)	(4,816)
Net loans and advances	2,102,031	1,226,949	3,328,980
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	2,666	4,806	7,472
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.3%	0.8%	0.5%
Total allowances as a percentage of total gross loans and advances	0.3%	0.6%	0.4%

At 31 Dec 2016			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	6,808	10,731	17,539
Collectively assessed	1,786,781	1,042,486	2,829,267
– impaired loans and advances	720	1,119	1,839
– non-impaired loans and advances	1,786,061	1,041,367	2,827,428
Total gross loans and advances to customers	1,793,589	1,053,217	2,846,806
Impairment allowances	(4,919)	(7,773)	(12,692)
– individually assessed	(2,960)	(5,099)	(8,059)
– collectively assessed	(1,959)	(2,674)	(4,633)
Net loans and advances	1,788,670	1,045,444	2,834,114
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	3,258	5,488	8,746
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.4%	1.0%	0.6%
Total allowances as a percentage of total gross loans and advances	0.3%	0.7%	0.4%

Movement in impairment allowances on loans and advances to customers

	Individually assessed HK\$m	Collectively assessed HK\$m	Total HK\$m
At 1 Jan 2017			
Amounts written off	(2,189)	(2,806)	(4,995)
Recoveries of loans and advances written off in previous years	180	713	893
Net charge to income statement (<i>note 2g</i>)	2,194	2,136	4,330
Unwinding of discount of loan impairment	(235)	(17)	(252)
Exchange and other adjustments	220	157	377
At 31 Dec 2017	8,229	4,816	13,045
At 1 Jan 2016			
Amounts written off	(2,334)	(2,694)	(5,028)
Recoveries of loans and advances written off in previous years	277	881	1,158
Net charge to income statement (<i>note 2g</i>)	3,380	2,065	5,445
Unwinding of discount of loan impairment	(310)	(58)	(368)
Exchange and other adjustments	6	(50)	(44)
At 31 Dec 2016	8,059	4,633	12,692

12 Financial investments

	2017 HK\$m	2016 HK\$m
Available-for-sale	1,419,930	1,574,584
– treasury and other eligible bills	539,014	688,369
– debt securities	871,641	877,504
– equity shares	9,275	8,711
Held-to-maturity	300,943	260,767
– treasury and other eligible bills	699	–
– debt securities	300,244	260,767
At 31 Dec	1,720,873	1,835,351

13 Assets pledged, assets transferred and collateral received

Financial assets pledged as collateral

	2017 HK\$m	2016 HK\$m
Treasury bills, debt securities, equities and deposits	225,590	206,526

The above shows assets where a charge has been granted to secure liabilities on a legal and contractual basis. These transactions are conducted under terms that are usual and customary to collateralised transactions including, where relevant, standard securities lending, repurchase agreements and derivative margining.

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

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

	2017		2016	
	Carrying amount of transferred assets HK\$m	Carrying amount of associated liabilities HK\$m	Carrying amount of transferred assets HK\$m	Carrying amount of associated liabilities HK\$m
Repurchase agreements	77,151	45,778	61,738	21,851
Securities lending agreements	3,209	63	3,506	–
	80,360	45,841	65,244	21,851

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

Collateral accepted as security for assets

	2017 HK\$m	2016 HK\$m
Fair value of the collateral permitted to sell or repledge in the absence of default	642,318	531,561
Fair value of collateral actually sold or repledged	102,382	86,287

These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements.

14 Investment in subsidiaries

Principal subsidiaries of the Bank

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

¹ People's Republic of China.

² Held indirectly.

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

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

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

The principal subsidiaries are regulated banking and insurance entities in the Asia-Pacific region and, as such, are required to maintain certain minimum levels of capital and liquid assets to support their operations. The effect of these regulatory requirements is to limit the extent to which the subsidiaries may transfer funds to the Bank in the form of repayment of shareholder loans or cash dividends.

Subsidiary with material non-controlling interest

	2017	2016
Hang Seng Bank Limited		
Ownership interest and voting rights held by non-controlling interests	37.86%	37.86%
	HK\$m	HK\$m
Profit attributable to non-controlling interests	7,579	6,138
Accumulated non-controlling interests of the subsidiary	54,919	50,601
Dividends paid to non-controlling interests	4,632	6,297
Summarised financial information (before intra-group eliminations):		
- Assets	1,478,418	1,377,242
- Liabilities	1,326,339	1,236,556
- Net operating income before loan impairment	35,498	30,563
- Profit for the year	20,003	16,204
- Other comprehensive income	3,969	(582)
- Total comprehensive income	23,972	15,622

15 Interests in associates and joint ventures

	2017	2016
	HK\$m	HK\$m
Share of net assets	140,670	121,985
Goodwill	4,071	3,787
Intangible assets	—	58
Deferred tax on intangible assets	—	(14)
Impairment	(24)	(24)
At 31 Dec	144,717	125,792

The above balance represented the group's interests in associates.

Principal associate

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

Bank of Communications Co., Ltd. is listed on recognised stock exchanges. The fair value represents valuation based on the quoted market price of the shares held (Level 1 in the fair value hierarchy) and amounted to HK\$81,987m at 31 December 2017 (2016: HK\$79,160m).

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

The group's significant influence in BoCom was established via representation on BoCom's Board of Directors and participation in a Technical Cooperation and Exchange Programme ('TCEP'). Under the TCEP, a number of HSBC staff have been seconded to assist in the maintenance of BoCom's financial and operating policies.

Impairment testing

At 31 December 2017, the fair value of the group's investment in BoCom had been below the carrying amount for approximately 68 months. As a result, the group performed an impairment test on the carrying amount, which confirmed that there was no impairment at 31 December 2017.

	At					
	31 Dec 2017			31 Dec 2016		
	VIU HK\$bn	Carrying value HK\$bn	Fair value HK\$bn	VIU HK\$bn	Carrying value HK\$bn	Fair value HK\$bn
BoCom	143.2	141.7	82.0	124.8	122.8	79.2

Basis of recoverable amount

The impairment test was performed by comparing the recoverable amount of BoCom, determined by a value-in-use ('VIU') calculation, with its carrying amount. The VIU calculation uses discounted cash flow projections based on management's estimates of earnings. Cash flows beyond the short to medium-term are then extrapolated in perpetuity using a long-term growth rate to derive a terminal value, which comprises the majority of the VIU. An imputed capital maintenance charge ('CMC') is calculated to reflect expected regulatory capital requirements, and is deducted from forecast cash flows. The principal inputs to the CMC calculation include estimates of asset growth, the ratio of risk-weighted assets to total assets, and the expected minimum regulatory capital requirements. An increase in the CMC as a result of a change to these principal inputs would reduce VIU. Additionally, management considers other factors (including qualitative factors) to ensure that the inputs to the VIU calculation remain appropriate. Significant management judgement is required in estimating the future cash flows of BoCom.

Key assumptions in VIU calculation

- Long-term profit growth rate: 3% (2016: 5%) for periods after 2020, which does not exceed forecast GDP growth in mainland China and is within the range forecast by external analysts.
- Long-term asset growth rate: 3% (2016: 4%) for periods after 2020, which is the rate that assets are expected to grow to achieve long-term profit growth of 3%.
- Discount rate: 11.85% (2016: 13%) which is based on a Capital Asset Pricing Model ('CAPM') calculation for BoCom, using market data. Management also compares the rate derived from the CAPM with discount rates from external sources. The discount rate used is within the range of 10.2% to 13.4% (2016: 10.2% to 15%) indicated by external sources.
- Loan impairment charge as a percentage of customer advances: ranges from 0.66% to 0.82% (2016: 0.72% to 0.87%) in the short to medium-term and are largely based on forecasts disclosed by external analysts. For periods after 2020, the ratio is 0.7% (2016: 0.7%), slightly higher than the historical average.
- Risk-weighted assets as a percentage of total assets: 62% (2016: 62%) for all forecast periods. This is consistent with the forecasts disclosed by external analysts.
- Cost-income ratio: ranges from 37.1% to 38% (2016: 40%) in the short-to medium-term. This is slightly higher than the forecasts disclosed by external analysts.

The long-term profit growth rate, long-term asset growth rate and discount rate assumptions were updated in 2017 to better align with market practice when setting long-term assumptions in VIU calculations. The long-term profit growth rate was set at the lower end of the range forecast by external analysts and there was a corresponding change to the long-term asset growth rate. These changes reduced management's uncertainty in respect of estimated future cash flows and accordingly the discount rate was set based on CAPM with no adjustment for uncertainty in future cash flows.

The following table shows the change to each key assumption in the VIU calculation that on its own would reduce the headroom to nil:

Key assumption	Changes to key assumption to reduce headroom to nil
<ul style="list-style-type: none"> • Long-term profit growth rate • Long-term asset growth rate • Discount rate • Loan impairment charge as a percentage of customer advances • Risk-weighted assets as a percentage of total assets • Cost-income ratio 	<ul style="list-style-type: none"> • Decrease by 7 basis points • Increase by 7 basis points • Increase by 9 basis points • Increase by 1 basis point • Increase by 44 basis points • Increase by 32 basis points

Notes on the Consolidated Financial Statements

The following table further illustrates the impact on VIU of reasonably possible changes to key assumptions. This reflects the sensitivity of the VIU to each key assumption on its own and it is possible that more than one favourable and/or unfavourable change may occur at the same time. The selected rates of reasonably possible changes to key assumptions is largely based on external analysts' forecasts which can change period to period.

	Favourable change			Unfavourable change		
	Increase in VIU bps	VIU HK\$bn	VIU HK\$bn	Decrease in VIU bps	VIU HK\$bn	VIU HK\$bn
At 31 December 2017						
Long-term profit growth rate	+200	51.5	194.7	-	-	143.2
Long-term asset growth rate	-20	4.2	147.4	+200	(55.4)	87.8
Discount rate	-35	5.7	148.9	+65	(9.5)	133.7
Loan impairment charge as a percentage of customer advances	2017 to 2020: 0.71% 2021 onwards: 0.70%	1.1	144.3	2017 to 2020: 0.90% 2021 onwards: 0.77%	(10.0)	133.2
Risk-weighted assets as a percentage of total assets	-60	1.9	145.1	+30	(1.0)	142.2
Cost-income ratio	-173	11.7	154.9	-	-	143.2
At 31 December 2016						
Long-term profit growth rate	-	-	124.8	-150	(25.7)	99.1
Long-term asset growth rate	-80	13.6	138.4	-	-	124.8
Discount rate	-100	18.1	142.9	-	-	124.8
Loan impairment charge as a percentage of customer advances	-	-	124.8	2016 to 2019: 0.93% 2020 onwards: 0.80%	(8.4)	116.4
Risk-weighted assets as a percentage of total assets	-30	0.8	125.6	+170	(4.7)	120.1
Cost-income ratio	-170	7.3	132.1	+250	(10.6)	114.2

Considering the interrelationship of the changes set out in the table above, management estimates that the reasonably possible range of VIU is HK\$115.1bn to HK\$165.2bn (2016: HK\$83.8bn to HK\$147.1bn).

Selected financial information of BoCom

The statutory accounting reference date of BoCom is 31 December. For the year ended 31 December 2017, the group included the associate's results on the basis of financial statements made up for the 12 months to 30 September 2017, but taking into account the financial effect of significant transactions or events in the period from 1 October 2017 to 31 December 2017.

	At 30 Sep	
	2017	2016
	HK\$m	HK\$m
Selected balance sheet information of BoCom		
Cash and balances at central banks	1,141,256	1,069,067
Loans and advances to banks and other financial institutions	940,983	786,695
Loans and advances to customers	5,179,210	4,390,644
Other financial assets	3,017,209	2,413,593
Prepayment, accrued income and other assets	458,039	382,370
Total assets	10,736,697	9,042,369
Deposits by banks and other financial institutions	2,868,142	2,306,842
Customer accounts	5,844,883	5,280,905
Other financial liabilities	967,143	542,533
Other liabilities	254,525	216,071
Total liabilities	9,934,693	8,346,351
Total equity	802,004	696,018
Total equity attributable to:		
– ordinary shareholders	723,784	625,727
– non-controlling interests	6,311	3,417
– preference shareholders	71,909	66,874
Reconciliation of BoCom's net assets to carrying amount in the group's consolidated financial statements		
The group's share of net assets	137,769	119,104
Add: Goodwill	3,958	3,681
Add: Intangible assets	–	44
Carrying amount	141,727	122,829
	For the 12 months ended 30 Sep	
	2017	2016
	HK\$m	HK\$m
Selected income statement information of BoCom		
Net interest income	148,688	160,016
Net fee and commission income	44,401	42,641
Loan impairment charges	(33,400)	(33,252)
Depreciation and amortisation	(10,460)	(9,437)
Tax expense	(17,411)	(21,734)
Profit for the year	80,172	78,796
Other comprehensive income	(4,860)	6,795
Total comprehensive income	75,312	85,591
Dividends received from BoCom	4,401	4,503

Other associates

Summarised aggregate financial information in respect of associates not individually material

	At	
	31 Dec	31 Dec
	2017	2016
	HK\$m	HK\$m
Carrying value	2,990	2,963
The group's share of:		
– assets	7,465	6,213
– liabilities	4,588	3,357
– profit or loss from continuing operations	160	167
– total comprehensive income	160	167
Other expense related to investment in an associate:		
– Impairment of an associate	24	24

At 31 December 2017, the group's share of associates' contingent liabilities was HK\$303,541m (2016: HK\$273,500m).

16 Goodwill and intangible assets

Goodwill and intangible assets include goodwill arising on business combinations, the present value of in-force long-term insurance business, and other intangible assets.

	2017 HK\$m	2016 HK\$m
Goodwill	7,128	6,201
Present value of in-force long-term insurance business	44,621	44,077
Other intangible assets	8,116	6,658
At 31 Dec	59,865	56,936

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

(i) PVIF specific assumptions

The following are the key long-term assumptions used in the computation of PVIF for Hong Kong, being the main life insurance operations:

	At	
	31 Dec 2017 %	31 Dec 2016 %
Weighted average risk free rate	2.02	2.09
Weighted average risk discount rate	6.20	6.34
Expenses inflation	3.00	3.00

(ii) Movement in PVIF for the year ended 31 December

	2017 HK\$m	2016 HK\$m
At 1 Jan	44,077	36,897
Value of new business written during the year	6,597	6,048
Movements arising from in-force business:		
– expected return	(3,687)	(2,622)
– experience variances	(180)	225
– changes in operating assumptions	(1,685)	2,675
Investment return variances	(638)	2,004
Changes in investment assumptions	(178)	(1,062)
Other adjustments	76	38
Changes in PVIF	305	7,306
Exchange differences and other	239	(126)
At 31 Dec	44,621	44,077

17 Property, plant and equipment

Movement in property, plant and equipment

	2017			2016		
	Land and buildings	Investment properties	Equipment	Land and buildings	Investment properties	Equipment
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Cost or valuation						
At 1 Jan	95,134	10,629	22,092	94,000	10,716	24,539
Exchange and other adjustments	621	2	585	(480)	(2)	(218)
Additions	765	—	2,232	489	—	2,520
Disposals	(312)	—	(2,292)	(20)	—	(4,749)
Transfers ¹	(5,106)	—	—	—	—	—
Elimination of accumulated depreciation on revalued land and buildings	(2,353)	—	—	(2,575)	—	—
Surplus on revaluation	9,479	1,379	—	3,825	36	—
Reclassifications	(609)	607	—	(105)	(121)	—
At 31 Dec	97,619	12,617	22,617	95,134	10,629	22,092
Accumulated depreciation						
At 1 Jan	169	—	16,046	167	—	19,024
Exchange and other adjustments	22	—	469	(3)	—	(167)
Charge for the year	2,678	—	1,972	2,598	—	1,895
Disposals	(306)	—	(2,180)	(18)	—	(4,706)
Elimination of accumulated depreciation on revalued land and buildings	(2,353)	—	—	(2,575)	—	—
At 31 Dec	210	—	16,307	169	—	16,046
Net book value at 31 Dec	97,409	12,617	6,310	94,965	10,629	6,046
Total at 31 Dec			116,336			111,640

¹ During the year, certain properties have been transferred to a fellow subsidiary as part of the Recovery and Resolution Plan as set out in the Report of Directors on page 7-8. The balance represented the carrying value of these properties on the date of transfer.

The carrying amount of land and buildings, had they been stated at cost less accumulated depreciation, would have been as follows:

	2017	2016
	HK\$m	HK\$m
Cost less accumulated depreciation	19,358	21,967

Valuation of land and buildings and investment properties

The group's land and buildings and investment properties were revalued in November 2017 and updated for any material changes at 31 December 2017. The basis of valuation for land and buildings and investment properties was open market value, depreciated replacement cost or surrender value as noted in note 1.2(g). The resultant values are Level 3 in the fair value hierarchy. The fair values for land and buildings are determined by using direct comparison approach which values the properties in their respective existing states and uses, assuming sale with immediate vacant possession and by making reference to comparable sales evidence. The valuations take into account the characteristics of the properties (unobservable inputs) which include the location, size, shape, view, floor level, year of completion and other factors collectively. The premium or discount applied to the characteristics of the properties is within minus 20% and plus 20%. In determining the open market value of investment properties, expected future cash flows have been discounted to their present values. The net book value of 'Land and buildings' includes HK\$8,853m (2016: HK\$12,249m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

Land and buildings and investment properties in Hong Kong, Macau and mainland China, represent 96% by value of the group's properties subject to valuation. The valuations were carried out by Cushman & Wakefield Limited who have recent experience in the location and type of properties and who are members of the Hong Kong Institute of Surveyors. Properties in 11 countries, representing 4% by value of the group's properties, were valued by different independent professionally qualified valuers.

18 Prepayments, accrued income and other assets

	2017	2016
	HK\$m	HK\$m
Prepayments and accrued income	24,541	21,505
Bullion	44,555	69,894
Acceptances and endorsements	36,720	32,290
Reinsurers' share of liabilities under insurance contracts (note 24)	15,734	11,368
Current tax assets	2,485	3,537
Other accounts	34,476	32,636
At 31 Dec	158,511	171,230

Prepayments, accrued income and other assets included HK\$93,610m (2016: HK\$84,162m) of financial assets, the majority of which were measured at amortised cost.

19 Customer accounts

	2017 HK\$m	2016 HK\$m
Current accounts	1,078,661	991,562
Savings accounts	3,057,145	2,946,379
Other deposit accounts	1,002,466	962,063
At 31 Dec	5,138,272	4,900,004

20 Trading liabilities

	2017 HK\$m	2016 HK\$m
Debt securities in issue	20,755	25,702
Short positions in securities	83,024	79,048
Deposits by banks	9,984	9,557
Customer accounts	117,602	74,163
At 31 Dec	231,365	188,470

21 Financial liabilities designated at fair value

	2017 HK\$m	2016 HK\$m
Debt securities in issue	11,010	14,814
Liabilities to customers under investment contracts	38,268	36,302
At 31 Dec	49,278	51,116

At 31 December 2017, the carrying amount of the debt securities in issue was HK\$27m higher than the contractual amount at maturity (2016: HK\$58m). At 31 December 2017, the accumulated loss in fair value attributable to changes in credit risk for debt securities in issue was HK\$8m (2016: HK\$39m gain).

22 Debt securities in issue

	2017 HK\$m	2016 HK\$m
Bonds and medium-term note	59,266	59,218
Other debt securities in issue	10,893	6,533
Total debt securities in issue	70,159	65,751
Included within:		
– trading liabilities (note 20)	(20,755)	(25,702)
– financial liabilities designated at fair value (note 21)	(11,010)	(14,814)
At 31 Dec	38,394	25,235

23 Accruals and deferred income, other liabilities and provisions

	2017 HK\$m	2016 HK\$m
Accruals and deferred income	25,880	24,409
Acceptances and endorsements	36,720	32,290
Share-based payment liability to HSBC Holdings plc	2,268	1,945
Other liabilities	45,193	39,676
Provisions for liabilities and charges	626	1,167
At 31 Dec	110,687	99,487

Accruals and deferred income, other liabilities and provisions included HK\$102,902m (2016: HK\$91,602m) of financial liabilities which were measured at amortised cost.

Movement in provision for liabilities and charges during the year is set out below:

	2017			2016		
	Restructuring costs	Others	Total	Restructuring costs	Others	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
At 1 Jan	786	381	1,167			
Additions	110	232	342	801	402	1,203
Amounts utilised	(728)	(84)	(812)	(200)	(68)	(268)
Unused amounts reversed	(14)	(109)	(123)	(438)	(97)	(535)
Exchange and other movements	38	14	52	(24)	(27)	(51)
At 31 Dec	192	434	626	786	381	1,167

24 Liabilities under insurance contracts

	2017			2016		
	Gross	Reinsurers' share ²	Net	Gross	Reinsurers' share ²	Net
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Non-linked insurance contracts¹						
At 1 Jan	342,134	(10,077)	332,057	298,576	(7,151)	291,425
Claims and benefits paid	(19,765)	1,727	(18,038)	(19,099)	319	(18,780)
Increase/(decrease) in liabilities to policyholders	65,671	(6,894)	58,777	63,473	(3,514)	59,959
Foreign exchange and other movements	3,308	(380)	2,928	(816)	269	(547)
At 31 Dec	391,348	(15,624)	375,724	342,134	(10,077)	332,057
Linked insurance contracts						
At 1 Jan	44,036	(1,291)	42,745	42,244	(1,392)	40,852
Claims and benefits paid	(7,239)	1,715	(5,524)	(2,395)	80	(2,315)
Increase in liabilities to policyholders	8,841	1,172	10,013	4,472	155	4,627
Foreign exchange and other movements	1,031	(1,706)	(675)	(285)	(134)	(419)
At 31 Dec	46,669	(110)	46,559	44,036	(1,291)	42,745
Total liabilities to policyholders	438,017	(15,734)	422,283	386,170	(11,368)	374,802

¹ Includes liabilities under non-life insurance contracts.

² Amounts recoverable from reinsurance of liabilities under insurance contracts are included in the consolidated balance sheet in 'Prepayment, accrued income and other assets'.

25 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.

		2017	2016
		HK\$m	HK\$m
US\$400m	Undated floating rate primary capital notes	3,126	3,102
MYR500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022 ¹	964	869
MYR500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017 ²	—	865
At 31 Dec		4,090	4,836

¹ The interest rate on the MYR500m 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.

² In Jun 2017, the group exercised its call option for MYR500m 4.35% callable subordinated bonds before expiry date.

Subordinated liabilities issued to group entities are not included in the above.

26 Preference shares

Irredeemable preference shares, issued and fully paid

	2017	2016
	HK\$m	HK\$m
At 1 Jan	26,879	28,415
Redeemed during the year	(6,022)	(1,550)
Exchange and other movements	180	14
At 31 Dec	21,037	26,879

The preference shares were issued at the then nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of 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 holders of the preference shares are entitled to one vote per share at shareholders' meetings of the Bank.

The number of issued non-cumulative irredeemable preference shares at 31 December 2017 was 2,478m (2016: 3,253m) and 775m were redeemed during the year. No non-cumulative irredeemable preference shares were issued during the year (2016: nil).

The number of issued cumulative irredeemable preference shares at 31 December 2017 was 200m (2016: 200m). No cumulative irredeemable preference shares were issued during the year (2016: nil).

There was INR870m (2016: INR870m) of authorised preference share capital, comprising 8.7m compulsorily convertible preference shares ('CCPS') of INR100 each in the share capital of a subsidiary, HSBC InvestDirect Securities (India) Private Limited ('HSBC InvestDirect'). The CCPS were issued and fully paid in 2009 at a nominal value of INR100 each. These shares may be converted into fully paid equity shares of HSBC InvestDirect at any time after one year to 10 years from the date of allotment of the CCPS by written notice. The conversion shall be made at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion. The CCPS shall carry a fixed dividend of 0.001% of the face value per annum. After 10 years following the allotment of the CCPS, all outstanding CCPS shall be converted at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion. HSBC InvestDirect did not convert any CCPS during 2017 (2016: nil). The number of issued CCPS at 31 December 2017 was 8.7m (2016: 8.7m). No CCPS were issued during the year (2016: nil).

27 Share capital

	2017	2016
	HK\$m	HK\$m
Ordinary share capital	116,103	114,359
Other ¹	35,257	–
At 31 Dec	151,360	114,359

Ordinary shares issued and fully paid

	2017		2016	
	HK\$m	Number	HK\$m	Number
At 1 Jan	114,359	45,743,491,798	96,052	38,420,982,901
Issued during the year	1,744	697,500,000	18,307	7,322,508,897
At 31 Dec	116,103	46,440,991,798	114,359	45,743,491,798

¹ In 2017, the Bank redeemed US\$775m (HK\$6,022m) of preference shares which were classified as a financial liability in the consolidated balance sheet (see note 26). The redemption was made by a payment out of distributable profits and the amount was transferred from retained earnings to share capital in accordance with the requirements of the Companies Ordinance. In 2013, the Bank redeemed US\$3,745m (HK\$29,235m) of preference shares in the same manner. This amount was also transferred from retained earnings to share capital during the year to conform to the current period treatment. The total amount transferred from retained earnings to share capital during the year in respect of these transactions was HK\$35,257m. This amount is non-distributable.

698m new ordinary shares were issued during 2017 (2016: 7,323m) at an issue price of HK\$2.5 each for general corporate purposes. The holders of the ordinary shares are entitled to receive dividends as declared from time to time, rank equally with regard to the Bank's residual assets and are entitled to one vote per share at shareholder meetings of the Bank.

28 Other equity instruments

Other equity instruments comprise additional tier 1 capital instruments in issue which are accounted for in equity.

	2017	2016
	HK\$m	HK\$m
US\$1,000m Floating rate perpetual subordinated loan, callable from Dec 2019 ¹	7,756	7,756
US\$900m Floating rate perpetual subordinated loan, callable from Dec 2019 ¹	6,981	6,981
At 31 Dec	14,737	14,737

¹ Interest rate at one year US dollar LIBOR plus 3.84%.

The additional tier 1 capital instruments are perpetual subordinated loans on which coupon payments may be cancelled at the sole discretion of the Bank. The subordinated loans will be written down at the point of non-viability on the occurrence of a trigger event as defined in the Banking (Capital) Rules. They rank higher than ordinary shares in the event of a wind-up.

29 Maturity analysis of assets and liabilities

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

	Due within 1 month	Due between 1 and 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
At 31 Dec 2017									
Assets									
Cash and sight balances at central banks	208,073	—	—	—	—	—	—	—	208,073
Items in the course of collection from other banks	25,714	—	—	—	—	—	—	—	25,714
Hong Kong Government certificates of indebtedness	267,174	—	—	—	—	—	—	—	267,174
Trading assets	—	—	—	—	—	—	496,434	—	496,434
Derivatives	—	—	—	—	—	—	295,363	4,880	300,243
Financial assets designated at fair value	1,151	472	2,634	11,273	3,126	103,990	—	—	122,646
Reverse repurchase agreements – non-trading	212,556	62,050	16,472	39,812	—	—	—	—	330,890
Placings with and advances to banks	282,259	74,043	37,210	30,874	8,619	—	—	—	433,005
Loans and advances to customers	664,326	315,163	538,683	1,011,144	812,709	(13,045)	—	—	3,328,980
Financial investments	205,333	352,076	364,037	489,165	301,021	9,241	—	—	1,720,873
Amounts due from Group companies	66,025	151,749	860	556	80	—	8,459	—	227,729
Interests in associates and joint ventures	—	—	—	—	—	144,717	—	—	144,717
Goodwill and intangible assets	—	—	—	—	—	59,865	—	—	59,865
Property, plant and equipment	—	—	—	—	—	116,336	—	—	116,336
Deferred tax assets	—	—	—	—	—	2,156	—	—	2,156
Prepayment, accrued income and other assets	51,204	28,554	13,862	11,098	7,193	46,600	—	—	158,511
Total assets	1,983,815	984,107	973,758	1,593,922	1,132,748	469,860	800,256	4,880	7,943,346
Liabilities									
Hong Kong currency notes in circulation	267,174	—	—	—	—	—	—	—	267,174
Items in the course of transmission to other banks	38,283	—	—	—	—	—	—	—	38,283
Repurchase agreements – non-trading	45,000	2,170	—	—	—	—	—	—	47,170
Deposits by banks	192,187	2,840	6,437	233	—	—	—	—	201,697
Customer accounts	4,727,204	217,307	177,150	16,337	274	—	—	—	5,138,272
Trading liabilities	—	—	—	—	—	—	231,365	—	231,365
Derivatives	—	—	—	—	—	—	305,076	4,277	309,353
Financial liabilities designated at fair value	199	—	2,621	8,365	—	38,093	—	—	49,278
Debt securities in issue	1,189	2,677	8,995	21,114	4,419	—	—	—	38,394
Retirement benefit liabilities	—	—	—	—	—	2,222	—	—	2,222
Amounts due to Group companies	106,368	1,919	519	47,643	96,243	—	12,996	—	265,688
Accruals and deferred income, other liabilities and provisions	45,746	37,421	18,088	4,164	233	5,035	—	—	110,687
Liabilities under insurance contracts ¹	6,595	—	—	—	—	431,422	—	—	438,017
Current tax liabilities	487	200	2,114	441	—	—	—	—	3,242
Deferred tax liabilities	—	—	—	—	—	24,391	—	—	24,391
Subordinated liabilities ²	—	—	—	964	—	3,126	—	—	4,090
Preference shares	—	—	—	—	—	21,037	—	—	21,037
Total liabilities	5,430,432	264,534	215,924	99,261	101,169	525,326	549,437	4,277	7,190,360

Notes on the Consolidated Financial Statements

	Due within 1 month	Due between 1 and 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
At 31 Dec 2016									
Assets									
Cash and sight balances at central banks	213,783	—	—	—	—	—	—	—	213,783
Items in the course of collection from other banks	21,401	—	—	—	—	—	—	—	21,401
Hong Kong Government certificates of indebtedness	242,194	—	—	—	—	—	—	—	242,194
Trading assets	—	—	—	—	—	—	371,634	—	371,634
Derivatives	—	—	—	—	—	—	470,681	9,126	479,807
Financial assets designated at fair value	39	822	2,990	11,545	2,457	88,163	—	—	106,016
Reverse repurchase agreements – non-trading	194,445	50,958	22,001	4,163	—	—	—	—	271,567
Placings with and advances to banks	301,295	92,212	41,753	20,404	7,547	—	—	—	463,211
Loans and advances to customers	558,198	291,528	465,166	816,370	715,544	(12,692)	—	—	2,834,114
Financial investments	242,389	416,605	367,518	544,873	255,251	8,715	—	—	1,835,351
Amounts due from Group companies	135,084	76,240	12,233	1,673	209	—	17,334	—	242,773
Interests in associates and joint ventures	—	—	—	—	—	125,792	—	—	125,792
Goodwill and intangible assets	—	—	—	—	—	56,936	—	—	56,936
Property, plant and equipment	—	—	—	—	—	111,640	—	—	111,640
Deferred tax assets	—	—	—	—	—	1,503	—	—	1,503
Prepayment, accrued income and other assets	38,585	33,731	14,128	10,553	2,451	71,782	—	—	171,230
Total assets	1,947,413	962,096	925,789	1,409,581	983,459	451,839	859,649	9,126	7,548,952
Liabilities									
Hong Kong currency notes in circulation	242,194	—	—	—	—	—	—	—	242,194
Items in the course of transmission to other banks	37,753	—	—	—	—	—	—	—	37,753
Repurchase agreements – non-trading	26,281	1,529	—	—	—	—	—	—	27,810
Deposits by banks	168,968	14,247	8,936	304	24	—	—	—	192,479
Customer accounts	4,481,361	232,651	163,848	21,710	434	—	—	—	4,900,004
Trading liabilities	—	—	—	—	—	—	188,470	—	188,470
Derivatives	—	—	—	—	—	—	460,076	2,382	462,458
Financial liabilities designated at fair value	206	—	4,401	10,150	222	36,137	—	—	51,116
Debt securities in issue	1,549	408	7,440	11,818	4,020	—	—	—	25,235
Retirement benefit liabilities	—	—	—	—	—	3,867	—	—	3,867
Amounts due to Group companies	99,072	961	301	3	84,288	—	13,413	—	198,038
Accruals and deferred income, other liabilities and provisions	37,411	38,329	15,005	2,896	231	5,615	—	—	99,487
Liabilities under insurance contracts ¹	2,263	—	—	—	—	383,907	—	—	386,170
Current tax liabilities	95	226	1,273	25	—	—	—	—	1,619
Deferred tax liabilities	—	—	—	—	—	21,401	—	—	21,401
Subordinated liabilities ²	—	—	865	—	869	3,102	—	—	4,836
Preference shares	—	—	—	—	—	26,879	—	—	26,879
Total liabilities	5,097,153	288,351	202,069	46,906	90,088	480,908	661,959	2,382	6,869,816

¹ Liabilities under insurance contracts for which notice on claims have been received are included under 'Due within 1 month'. The remaining balance is included under 'No contractual maturity'.

² The maturity for subordinated liabilities is based on the earliest date on which the group is required to pay, i.e. the callable date.

30 Analysis of cash flows payable under financial liabilities by remaining contractual maturities

	On demand HK\$m	Due within 3 months HK\$m	Due between 3 and 12 months HK\$m	Due between 1 and 5 years HK\$m	Due after 5 years HK\$m	Total HK\$m
At 31 Dec 2017						
Hong Kong currency notes in circulation	267,174	–	–	–	–	267,174
Items in the course of transmission to other banks	–	38,283	–	–	–	38,283
Repurchase agreements – non-trading	11,829	35,554	–	–	–	47,383
Deposits by banks	163,030	32,048	6,467	267	–	201,812
Customer accounts	4,229,543	717,651	179,389	17,795	281	5,144,659
Trading liabilities	231,365	–	–	–	–	231,365
Derivatives	304,970	412	1,820	1,253	411	308,866
Financial liabilities designated at fair value	199	32	2,724	8,524	38,069	49,548
Debt securities in issue	40	4,026	9,521	22,421	4,753	40,761
Amounts due to Group companies	40,004	82,614	4,495	67,306	113,635	308,054
Other financial liabilities	8,870	69,010	16,515	3,287	218	97,900
Subordinated liabilities	–	25	74	1,361	3,634	5,094
Preference shares	–	283	412	2,781	27,990	31,466
	5,257,024	979,938	221,417	124,995	188,991	6,772,365
Loan commitments	1,821,774	640,726	14,437	4,678	97	2,481,712
Financial guarantee and credit risk related guarantee contracts	57,353	–	–	–	–	57,353
	7,136,151	1,620,664	235,854	129,673	189,088	9,311,430
At 31 Dec 2016						
Hong Kong currency notes in circulation	242,194	–	–	–	–	242,194
Items in the course of transmission to other banks	–	37,753	–	–	–	37,753
Repurchase agreements – non-trading	14,987	12,833	–	–	–	27,820
Deposits by banks	132,574	50,929	9,096	317	27	192,943
Customer accounts	4,009,208	706,984	167,132	24,172	469	4,907,965
Trading liabilities	188,470	–	–	–	–	188,470
Derivatives	459,667	523	999	545	26	461,760
Financial liabilities designated at fair value	206	56	4,594	10,437	36,330	51,623
Debt securities in issue	–	2,170	7,658	12,412	4,455	26,695
Amounts due to Group companies	47,847	66,251	2,199	10,088	95,265	221,650
Other financial liabilities	12,634	58,489	12,856	1,711	210	85,900
Subordinated liabilities	–	29	933	313	4,356	5,631
Preference shares	–	225	531	3,022	34,433	38,211
	5,107,787	936,242	205,998	63,017	175,571	6,488,615
Loan commitments	1,699,275	567,212	16,580	4,486	64	2,287,617
Financial guarantee and credit risk related guarantee contracts	64,017	–	–	–	–	64,017
	6,871,079	1,503,454	222,578	67,503	175,635	8,840,249

The balances in the above tables incorporates all cash flows relating to principal and future coupon payments on an undiscounted basis (except for trading liabilities and trading derivatives). Trading liabilities and trading derivatives have been included in the 'On demand' time bucket as trading liabilities are typically held for short periods of time. The undiscounted cash flows payable under hedging derivative liabilities are classified according to their contractual maturity. Investment contract liabilities have been included in financial liabilities designated at fair value, whereby the policyholders have the options to surrender or transfer at any time, and are reported in the 'Due after 5 years' time bucket. A maturity analysis prepared on the basis of the earliest possible contractual repayment date (assuming that all surrender and transfer options are exercised) would result in all investment contracts being presented as falling due within one year or less. The undiscounted cash flows potentially payable under loan commitments and financial guarantee contracts are classified on the basis of the earliest date they can be called. Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice.

31 Contingent liabilities and commitments

(a) Off-balance sheet contingent liabilities and commitments

	2017 HK\$m	2016 HK\$m
Contingent liabilities and financial guarantee contracts		
Guarantees and irrevocable letters of credit pledged as collateral security	288,833	257,863
Other contingent liabilities	1,059	1,696
At 31 Dec	289,892	259,559
Commitments		
Documentary credits and short term trade-related transactions	28,045	30,080
Forward asset purchases and forward deposits placed	8,198	6,235
Undrawn formal standby facilities, credit lines and other commitments to lend	2,445,468	2,251,302
At 31 Dec	2,481,711	2,287,617

The above table discloses the nominal principal amounts of commitments (excluding capital commitments), guarantees and other contingent liabilities, which represent the amounts at risk should contracts be fully drawn upon and clients default. The amount of the loan commitments shown above reflects, where relevant, the expected level of take-up of pre-approved facilities. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of the contractual amounts is not representative of future liquidity requirements.

(b) Guarantees (including financial guarantee contracts)

The group provides guarantees and similar undertakings on behalf of both third-party customers and other entities within the Group. These guarantees are generally provided in the normal course of banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make, were as follows:

	2017 HK\$m	2016 HK\$m
Guarantees in favour of third parties	270,925	235,991
– financial guarantees ¹	50,621	52,831
– other guarantees ²	220,304	183,160
Guarantees in favour of other HSBC Group entities	17,908	21,872
At 31 Dec	288,833	257,863

¹ Financial guarantees are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.

² Other guarantees include re-insurance letters of credit related to particular transactions, trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment, performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees.

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures from guarantees are captured and managed in accordance with HSBC's overall credit risk management policies and procedures. Guarantees are subject to an annual credit review process.

32 Other commitments

Capital commitments

At 31 December 2017, capital commitments, mainly related to the commitment for purchase of premises, were HK\$7,097m (2016: HK\$2,945m).

Lease commitments

The group leases certain properties and equipment under operating leases. The leases normally run for a period of one to 10 years and may include an option to renew. Lease payments are usually adjusted annually to reflect market rentals. None of the leases include contingent rentals. Future minimum lease payments under non-cancellable operating leases for premises and equipment are as follows:

	2017 HK\$m	2016 HK\$m
Amounts payable within		
– one year or less	2,948	2,974
– five years or less but over one year	4,277	4,545
– over five years	874	658
At 31 Dec	8,099	8,177

33 Offsetting of financial assets and financial liabilities

	Amounts subject to enforceable netting arrangements								Balance sheet total HK\$m
	Effects of offsetting in the balance sheet			Amounts not offset in the balance sheet					
	Gross amounts HK\$m	Amounts offset HK\$m	Amounts reported in the balance sheet HK\$m	Financial instruments HK\$m	Non-cash collateral HK\$m	Cash collateral HK\$m	Net amount HK\$m	Amounts not subject to enforceable netting arrangements ¹ HK\$m	
At 31 Dec 2017									
Financial assets²									
Derivatives	353,713	(77,624)	276,089	(234,555)	(4,926)	(28,992)	7,616	24,154	300,243
Reverse repos, stock borrowing and similar agreements classified as:	550,165	(12,689)	537,476	–	(537,348)	(62)	66	23,487	560,963
– trading assets	8,966	–	8,966	–	(8,966)	–	–	–	8,966
– non-trading assets	541,199	(12,689)	528,510	–	(528,382)	(62)	66	23,487	551,997
Loans and advances to customers at amortised cost	–	–	–	–	–	–	–	–	–
	903,878	(90,313)	813,565	(234,555)	(542,274)	(29,054)	7,682	47,641	861,206
Financial liabilities³									
Derivatives	366,456	(77,624)	288,832	(234,555)	(4,738)	(27,959)	21,580	20,521	309,353
Repos, stock lending and similar agreements	94,755	(12,689)	82,066	–	(81,847)	–	219	27,617	109,683
– trading liabilities	687	–	687	–	(686)	–	1	–	687
– non-trading liabilities	94,068	(12,689)	81,379	–	(81,161)	–	218	27,617	108,996
Customer accounts at amortised cost	–	–	–	–	–	–	–	–	–
	461,211	(90,313)	370,898	(234,555)	(86,585)	(27,959)	21,799	48,138	419,036
At 31 Dec 2016									
Financial assets²									
Derivatives	528,961	(72,599)	456,362	(339,755)	(19,420)	(38,762)	58,425	23,445	479,807
Reverse repos, stock borrowing and similar agreements classified as:	451,804	(2,358)	449,446	–	(446,189)	(455)	2,802	14,608	464,054
– trading assets	1,393	–	1,393	–	(1,387)	–	6	–	1,393
– non-trading assets	450,411	(2,358)	448,053	–	(444,802)	(455)	2,796	14,608	462,661
Loans and advances to customers at amortised cost	15,042	(15,042)	–	–	–	–	–	–	–
	995,807	(89,999)	905,808	(339,755)	(465,609)	(39,217)	61,227	38,053	943,861
Financial liabilities³									
Derivatives	511,784	(72,599)	439,185	(339,755)	(6,286)	(49,836)	43,308	23,273	462,458
Repos, stock lending and similar agreements classified as:	62,679	(2,358)	60,321	–	(60,079)	(2)	240	12,590	72,911
– trading liabilities	142	–	142	–	(142)	–	–	–	142
– non-trading liabilities	62,537	(2,358)	60,179	–	(59,937)	(2)	240	12,590	72,769
Customer accounts at amortised cost	15,042	(15,042)	–	–	–	–	–	–	–
	589,505	(89,999)	499,506	(339,755)	(66,365)	(49,838)	43,548	35,863	535,369

¹ These exposures continue to be secured by financial collateral, but we may not have sought or been able to obtain a legal opinion evidencing enforceability of the offsetting right.

² Amounts presented in the balance sheet included balances due from Group companies of HK\$262,159m (2016: HK\$254,849m).

³ Amounts presented in the balance sheet included balances due to Group companies of HK\$132,091m (2016: HK\$160,702m).

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

The 'Amounts not offset in the balance sheet' for derivatives and reverse repurchase/repurchase, stock borrowing/lending and similar arrangements include transactions where:

- the counterparty has an offsetting exposure with the group and a master netting or similar arrangement is in place with a right of set off only in the event of default, insolvency or bankruptcy, or the offset criteria are otherwise not satisfied; and
- cash and non-cash collaterals are received and pledged in respect of the transactions described above.

34 Segmental analysis

The group's operating segments are organised into four global businesses and a Corporate Centre. The group's chief operating decision-maker, the Executive Committee ('EXCO'), regularly reviews operating activities on a number of bases, including by global businesses and by countries. Although the chief operating decision-maker reviews information on a number of bases, business performance is assessed and capital resources are allocated by global business, and the segmental analysis is presented on that basis. The global businesses are therefore considered our reportable segments under HKFRS 8.

Notes on the Consolidated Financial Statements

Information provided to EXCO is measured in accordance with HKFRSs. The group's operations are closely integrated and, accordingly, the presentation of data includes internal allocations of certain items of income and expenses. These allocations include the costs of certain support services and global functions to the extent that they can be meaningfully attributed to operational business lines and geographical regions. While such allocations have been made on a systematic and consistent basis, they necessarily involve a degree of subjectivity. Costs which are not allocated to global businesses are included in the 'Corporate Centre'. Where relevant, income and expenses amounts presented include the results of inter-segment funding along with inter-company and inter-business line transactions. All such transactions are undertaken on arm's length terms. The intra-group elimination items for the global businesses are presented in the Corporate Centre.

The group provides a comprehensive range of banking and related financial services to its customers organised by global business:

- Retail Banking and Wealth Management ('RBWM') serves personal customers. We take deposits and provide transactional banking services to enable customers to manage their day to day finances and save for the future. We selectively offer credit facilities to assist customers in their short or longer-term borrowing requirements; and we provide financial advisory, broking, insurance and investment services to help them manage and protect their financial futures.
- Commercial Banking ('CMB') is segmented into Corporate, to serve both corporate and mid-market companies with more sophisticated financial needs, and Business Banking, to serve small- and medium-sized enterprises ('SMEs'), enabling differentiated coverage of our target customers. This allows us to provide continuous support to companies as they grow both domestically and internationally, and ensures a clear focus on internationally aspirant customers.
- Global Banking and Markets ('GB&M') provides tailored financial solutions to major government, corporate and institutional clients worldwide. GB&M operates a long-term relationship management approach to build a full understanding of clients' financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs.
- Global Private Banking ('GPB') provides investment management and trustee solutions to high net worth individuals and their families. We aim to meet the needs of our clients by providing excellent customer service, leveraging our global footprint and offering a comprehensive suite of solutions.
- Corporate Centre was established to align certain functions of the group. The Corporate Centre includes Balance Sheet Management, certain interests in associates and joint ventures, as well as the results of our financing operations and central support costs with associated recoveries.

Performance by global business is presented in the 'Financial Review' section.

Information by geographical region

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Intra-segment elimination HK\$m	Total HK\$m
2017				
Total operating income	187,935	70,397	(3,099)	255,233
Profit before tax	73,577	42,042	–	115,619
Total assets	5,643,940	2,923,926	(624,520)	7,943,346
Total liabilities	5,263,539	2,551,341	(624,520)	7,190,360
Credit commitments and contingent liabilities (contract amounts)	1,500,456	1,271,147	–	2,771,603
2016				
Total operating income	165,957	70,491	(3,710)	232,738
Profit before tax	60,645	42,062	–	102,707
Total assets	5,416,727	2,625,900	(493,675)	7,548,952
Total liabilities	5,062,172	2,301,319	(493,675)	6,869,816
Credit commitments and contingent liabilities (contract amounts)	1,413,979	1,133,197	–	2,547,176

Information by country

	Revenue ¹		Non-current assets ²	
	2017 HK\$m	2016 HK\$m	2017 HK\$m	2016 HK\$m
Hong Kong	125,698	108,165	111,164	106,513
Mainland China	14,264	14,307	150,778	130,167
Australia	6,636	6,537	871	821
India	8,372	7,761	2,108	1,919
Indonesia	4,395	4,467	3,851	3,810
Malaysia	5,663	5,794	833	761
Singapore	9,054	9,327	1,404	1,333
Taiwan	3,295	2,798	2,325	2,127
Other	9,066	8,996	2,963	2,840
Total	186,443	168,152	276,297	250,291

¹ Revenue (defined as 'Net operating income before loan impairment charges and other credit risk provisions') is attributable to countries based on the location of the principal operations of the subsidiary or branch.

² Non-current assets consist of property, plant and equipment, goodwill, other intangible assets, interests in associates and joint ventures and certain other assets.

35 Related party transactions

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, retirement benefit plans for the group's employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

(a) Inter-company

The group is wholly owned by HSBC Asia Holdings B.V, HSBC Asia Holdings B.V. is in turn wholly owned by HSBC Asia Holdings (UK) Limited, which is wholly owned by HSBC Holdings B.V, HSBC Holdings B.V. is wholly owned by HSBC Finance (Netherlands), which is wholly owned by HSBC Holdings plc (incorporated in England).

The group entered into transactions with its fellow subsidiaries in the normal course of business, including the acceptance and placement of interbank deposits, correspondent banking transactions and off-balance sheet transactions. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third-party counterparties.

The group shares the costs of certain IT projects with its fellow subsidiaries and also used certain processing services of fellow subsidiaries on a cost recovery basis. The Bank also acted as agent for the distribution of retail investment funds for fellow subsidiaries and paid professional fees for services provided by fellow subsidiaries. The commissions and fees in these transactions and services are priced on an arm's length basis.

In 2017, the group acquired HSBC International Trustee Limited from HSBC Private Bank Holdings (Suisse) SA, a fellow subsidiary company of the group. The transaction was made on an arm's length basis.

As part of the recovery and resolution plan, a new service company ('the ServCo'), which is not a subsidiary of the group but is indirectly held by the HSBC Holdings plc, has been set up in Hong Kong. In 2017, the group began to transfer certain properties and employees performing shared services to the ServCo. There were no changes to employment terms and conditions or pension benefits of these employees. Following these transfers, the ServCo has started to provide services to the group and the group recognised a management charge of HK\$238m to the ServCo for these services, which is included under 'General and administrative expenses'.

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 were as follows:

	2017			2016		
	Immediate holding company	Ultimate holding company	Fellow subsidiaries	Immediate holding company	Ultimate holding company	Fellow subsidiaries
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
Income and expenses for the year						
Interest income	–	–	2,447	–	–	1,242
Interest expense ¹	2,739	1,709	625	1,232	559	517
Fee income	–	41	2,605	–	–	2,482
Fee expense	–	–	1,100	–	–	971
Other operating income	–	1,201	2,506	–	826	2,346
Other operating expenses ²	2	2,879	9,632	6	2,387	7,681
At 31 Dec						
Assets	1	713	306,099	1	396	353,045
– trading assets ³	–	202	8,270	–	14	17,320
– derivative assets	–	–	79,084	–	–	110,669
– other assets ³	1	511	218,745	1	382	225,056
Liabilities	71,700	94,460	190,831	92,667	26,404	221,589
Trading liabilities ³	–	2	12,994	–	13	13,400
Financial liabilities designated at fair value ^{3,4}	–	35,866	15	–	–	8
Derivative liabilities	–	–	70,266	–	–	115,743
Other liabilities ³	515	1,067	107,449	510	7,714	92,338
Subordinated liabilities ^{3,5}	50,255	57,525	–	65,378	18,677	–
Preference shares	20,930	–	107	26,779	–	100
Guarantees	–	–	17,908	–	–	21,872
Commitments	–	–	14,372	–	–	2,578

¹ Interest expense included distribution on preference shares and interest on subordinated liabilities.

² In 2017, payments were made of HK\$432m (2016: HK\$682m) for software costs which were capitalised as intangible assets in the balance sheet of the group.

³ These balances are presented under 'Amounts due from/to Group companies' in the consolidated balance sheet.

⁴ The balance included subordinated liabilities of HK\$35,866m to meet Total Loss Absorbing Capacity ('TLAC') requirement (2016: nil).

⁵ The balance included subordinated liabilities of HK\$89,889m to meet TLAC requirement (2016: HK\$63,982m).

(b) Share option and share award schemes

The group participates in various share option and share plans operated by HSBC whereby share options or shares of HSBC are granted to employees of the group. As disclosed in note 4(a), the group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of share options is treated as a capital contribution and is recorded within 'Other reserves'. In respect of share awards, the group recognises a liability to the ultimate holding company over the vesting period. This liability is measured at the fair value of the shares at each reporting date, with changes since the award dates adjusted through the capital contribution account within 'Other reserves'. The balances of the capital contribution and the liability at 31 December 2017 amounted to HK\$2,901m and HK\$2,268m respectively (2016: HK\$3,225m and HK\$1,945m respectively).

Notes on the Consolidated Financial Statements

(c) Pension funds

At 31 December 2017, HK\$15.1bn (2016: HK\$14.0bn) of pension fund assets under defined benefits and defined contribution schemes for group employees were under management by group companies. Total fees paid or payable by pension plans to group companies for providing fund management, administrative and trustee services amounted to HK\$27m for the year (2016: HK\$21m).

(d) Associates and joint ventures

The group provides certain banking and financial services to associates and joint ventures, including loans, overdrafts, interest and non-interest bearing deposits and current accounts. Details of interests in associates and joint ventures are given in note 15. Transactions and balances during the year with associates and joint ventures were as follows:

	2017		2016	
	Highest balance during the year	Balance at 31 December	Highest balance during the year	Balance at 31 December
	HK\$m	HK\$m	HK\$m	HK\$m
Amounts due from associates – unsubordinated	24,178	19,793	24,147	22,268
Amounts due from joint ventures – unsubordinated	–	–	3	–
	24,178	19,793	24,150	22,268
Amounts due to associates	20,454	9,632	8,625	4,464
Commitments	1	1	1	1

The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The transactions resulting in amounts due to and from associates and joint ventures arose in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third-party counterparties.

(e) Key Management Personnel

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and the group. It includes members of the Board of Directors and Executive Committee of the Bank and the Board of Directors and Group Managing Directors of HSBC Holdings plc.

The following table shows the expense in respect of compensation for Key Management Personnel of the Bank for services rendered to the Bank:

	2017	2016
	HK\$m	HK\$m
Salaries and other short-term benefits	308	285
Retirement benefits	10	10
Share-based payments	110	111
	428	406

Transactions, arrangements and agreements involving Key Management Personnel

	2017	2016
	HK\$m	HK\$m
During the year		
Highest average assets ¹	36,413	21,374
Highest average liabilities ¹	55,629	33,658
Contribution to group's profit before tax	899	599
At the year end		
Guarantees	10,249	3,547
Commitments	2,961	2,623

¹ The disclosure of the highest average balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions, arrangements and agreements are entered into by the group with companies that may be controlled by Key Management Personnel of the group and their immediate relatives. These transactions are primarily loans and deposits, and were entered into in the ordinary course of business and on substantially the same terms, including interest rates and security, as comparable transactions with persons or companies of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

No impairment losses have been recorded against balances outstanding during the year with Key Management Personnel, and there are no specific impairment allowances on balances with Key Management Personnel at the year end (2016: nil).

(f) Loans to directors

Directors are defined as the Directors of the Bank, its ultimate holding company, HSBC Holdings plc and intermediate companies. Loans to directors also include loans to companies that are controlled by, and entities that are connected with these directors. Particulars of loans to directors disclosed pursuant to section 17 of the Companies (Disclosure of Information about Benefits of Directors) Regulation are as follows:

	Aggregate amount outstanding at 31 Dec		Maximum aggregate amount outstanding during the year	
	2017 HK\$m	2016 HK\$m	2017 HK\$m	2016 HK\$m
By the Bank	1,090	1,063	1,213	1,279
By subsidiaries	—	—	1	1
	1,090	1,063	1,214	1,280

These amounts include principal and interest, and the maximum liability that may be incurred under guarantees.

36 Fair values of financial instruments carried at fair value

The fair value of financial instruments is generally measured on the basis of the individual financial instrument. However, in cases where the group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the group measures the fair value of the group of financial instruments on a net basis, but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the HKFRS offsetting criteria as described in note 33.

The following table provides an analysis of the basis for the valuation of financial instruments carried at fair value:

	Fair Value Hierarchy			Third-party total HK\$m	Inter-company ² HK\$m	Total HK\$m
	Level 1 HK\$m	Level 2 HK\$m	Level 3 HK\$m			
At 31 Dec 2017						
Assets						
Trading assets ¹	300,646	195,575	213	496,434	—	496,434
Derivatives	4,773	215,869	517	221,159	79,084	300,243
Financial assets designated at fair value	90,641	23,567	8,438	122,646	—	122,646
Available-for-sale investments	916,385	498,512	5,033	1,419,930	—	1,419,930
Liabilities						
Trading liabilities ¹	79,209	141,972	10,184	231,365	—	231,365
Derivatives	4,501	232,627	1,959	239,087	70,266	309,353
Financial liabilities designated at fair value ¹	—	49,278	—	49,278	—	49,278
At 31 Dec 2016						
Assets						
Trading assets ¹	239,646	131,285	703	371,634	—	371,634
Derivatives	3,673	364,062	1,403	369,138	110,669	479,807
Financial assets designated at fair value	72,736	29,524	3,756	106,016	—	106,016
Available-for-sale investments	1,058,461	510,357	5,766	1,574,584	—	1,574,584
Liabilities						
Trading liabilities ¹	75,880	106,768	5,822	188,470	—	188,470
Derivatives	3,684	340,336	2,695	346,715	115,743	462,458
Financial liabilities designated at fair value ¹	—	50,875	241	51,116	—	51,116

¹ Amounts with HSBC Group entities are not reflected here.

² Derivatives balances with HSBC Group entities are largely under 'Level 2'.

Transfers between Level 1 and Level 2 fair values

	Assets				Liabilities		
	Available-for-sale HK\$m	Held for trading HK\$m	Designated at fair value HK\$m	Derivatives HK\$m	Held for trading HK\$m	Designated at fair value HK\$m	Derivatives HK\$m
At 31 Dec 2017							
Transfers from Level 1 to Level 2	5,424	9,402	—	—	—	—	—
Transfers from Level 2 to Level 1	63,280	—	—	—	—	—	—
At 31 Dec 2016							
Transfers from Level 1 to Level 2	1,259	—	947	—	—	—	34
Transfers from Level 2 to Level 1	—	—	—	—	2,646	—	—

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period. Transfers into and out of Levels of the fair value hierarchy are primarily attributable to changes in observability of valuation inputs and price transparency.

Notes on the Consolidated Financial Statements

Movements in Level 3 financial instruments

Balances reported in Level 3 increased, mainly in financial assets designated at fair value due to growth in insurance business, and in trading liabilities from increased structured deposits. There were no material transfers from/to Level 1 and 2 as a result of change in observability of valuation inputs in 2017 (2016: immaterial).

Control framework

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

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. For fair values determined using valuation models, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

Changes in fair value are generally subject to a profit and loss analysis process. This process disaggregates changes in fair value into three high level categories: (i) portfolio changes, such as new transactions or maturing transactions; (ii) market movements, such as changes in foreign exchange rates or equity prices; and (iii) other, such as changes in fair value adjustments.

To this end, the ultimate responsibility for the determination of fair values lies within the Finance function, which reports to the Group Finance Director. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

Determination of fair value

Fair values are determined according to the following hierarchy:

- Level 1 – Valuation technique using quoted market price: Financial instruments with quoted prices for identical instruments in active markets that the group can access at the measurement date.
- Level 2 – Valuation technique using observable inputs: Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- Level 3 – Valuation technique with significant unobservable inputs: Financial instruments valued using valuation techniques where one or more significant inputs are unobservable.

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

Financial liabilities measured at fair value

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes.

Fair value adjustments

Fair value adjustments are adopted when the group determines that there are additional factors that would be considered relevant by a market participant that are not incorporated within the valuation model. Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement, such as when models are enhanced, fair value adjustments may no longer be required.

Risk-related adjustments

(i) Bid-offer

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

(ii) Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, an adjustment may be necessary to reflect the likelihood that market participants would adopt more conservative values for uncertain parameters and/or model assumptions, than those used in the group's valuation model.

(iii) Credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA')

The CVA is an adjustment to the valuation of over-the-counter ('OTC') derivative contracts to reflect the possibility that the counterparty may default and the group may not receive the full market value of the transactions.

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

The group calculates a separate CVA and DVA for each legal entity, and for each counterparty to which the entity has exposure. With the exception of central clearing parties, all third-party counterparties are included in the CVA and DVA calculations, and these adjustments are not netted across group entities.

The group calculates the CVA by applying the probability of default ('PD') of the counterparty, conditional on the non-default of the group, to the group's expected positive exposure to the counterparty and multiplying the result by the loss expected in the event of default. Conversely, the group calculates the DVA by applying the PD of the group, conditional on the non-default of the counterparty, to the

expected positive exposure of the counterparty to the group and multiplying the result by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

For most products the group uses a simulation methodology, which incorporates a range of potential exposures over the life of the portfolio, to calculate the expected positive exposure to a counterparty. The simulation methodology includes credit mitigants, such as counterparty netting agreements and collateral agreements with the counterparty.

The methodologies do not, in general, account for 'wrong-way risk' which arises when the underlying value of the derivative prior to any CVA is positively correlated to the PD of the counterparty. When there is significant wrong-way risk, a trade-specific approach is applied to reflect this risk in the valuation.

(iv) Funding fair value adjustment ('FFVA')

The FFVA is calculated by applying future market funding spreads to the expected future funding exposure of any uncollateralised component of the OTC derivative portfolio. The expected future funding exposure is calculated by a simulation methodology, where available and is adjusted for events that may terminate the exposure, such as the default of the group or the counterparty. The FFVA and DVA are calculated independently.

(v) Model limitation

Models used for portfolio valuation purposes may be based upon a simplifying set of assumptions that do not capture all material market characteristics. In these circumstances, model limitation adjustments are adopted.

(vi) Inception profit (Day 1 profit or loss reserves)

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

Effects of changes in significant non-observable assumptions to reasonably possible alternatives

The key unobservable inputs to Level 3 financial instruments include volatility and correlation for structured notes and deposits valued using option models, bid quotes for corporate bonds valued using approaches that take into account of market comparables, and multiple items for private equity and strategic investments. In the absence of an active market, the fair value of private equity and strategic investments is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. The change in fair values due to changes in reasonably possible alternative assumptions for these unobservable inputs is not significant.

37 Fair values of financial instruments not carried at fair value

Fair values of financial instruments not carried at fair value and bases of valuation

	Fair Value Hierarchy				Total HK\$m
	Carrying amount HK\$m	Quoted market price Level 1 HK\$m	Observable inputs Level 2 HK\$m	Significant unobservable inputs Level 3 HK\$m	
At 31 Dec 2017					
Assets					
Reverse repurchase agreements – non-trading	330,890	–	318,849	11,927	330,776
Placings with and advances to banks	433,005	–	418,652	14,561	433,213
Loans and advances to customers	3,328,980	–	92,146	3,230,365	3,322,511
Financial investments – debt securities	300,244	6,244	303,240	–	309,484
Liabilities					
Repurchase agreements – non-trading	47,170	–	47,155	–	47,155
Deposits by banks	201,697	–	201,456	233	201,689
Customer accounts	5,138,272	–	5,138,352	–	5,138,352
Debt securities in issue	38,394	–	38,279	–	38,279
Subordinated liabilities	4,090	–	993	2,773	3,766
Preference Shares	21,037	–	–	21,539	21,539
At 31 Dec 2016					
Assets					
Reverse repurchase agreements – non-trading	271,567	–	260,167	11,839	272,006
Placings with and advances to banks	463,211	–	451,012	12,215	463,227
Loans and advances to customers	2,834,114	–	74,856	2,746,942	2,821,798
Financial investments – debt securities	260,767	5,099	257,290	–	262,389
Liabilities					
Repurchase agreements – non-trading	27,810	–	27,809	–	27,809
Deposits by banks	192,479	–	192,133	328	192,461
Customer accounts	4,900,004	–	4,900,114	–	4,900,114
Debt securities in issue	25,235	–	25,269	–	25,269
Subordinated liabilities	4,836	–	1,763	2,263	4,026
Preference Shares	26,879	–	–	27,285	27,285

Other financial instruments not carried at fair value are typically short-term in nature or re-price to current market rates frequently. Accordingly, their carrying amount is a reasonable approximation of fair value.

Valuation

The fair values of financial instruments that are not carried at fair value on the balance sheet are calculated as described below.

Repurchase and reverse repurchase agreements – non-trading

Fair values are estimated by using discounted cash flows, applying current rates. Fair values approximate carrying amounts as their balances are generally short dated.

Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors. The fair value of a loan reflects loan impairments at the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

Deposits by banks and customer accounts

Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is approximated by its carrying value.

Debt securities in issue and subordinated liabilities

Fair values are estimated by discounting future cash flows using discount rates for the applicable maturities and taking own credit spread into account.

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

38 Structured entities

The group enters into certain transactions with customers in the ordinary course of business which involve the use of structured entities ('SEs'). The group's arrangements that involve SEs are authorised centrally when they are established to ensure appropriate purpose and governance. The activities of SEs administered by the group are closely monitored by senior management. The group's transactions with consolidated and unconsolidated SEs are set out below.

Structured credit transactions

The group provides structured credit products to third-party professional and institutional investors who wish to obtain exposure to a reference portfolio of debt instruments. In such structures, the investor receives returns referenced to the underlying portfolio by purchasing notes issued by the SEs. The group enters into contracts with the SE, including derivatives, in order to pass the required risks and rewards of the reference portfolios to the SEs.

Securitisations by the group

The group uses SEs to securitise customer loans and advances that it has originated in order to diversify its sources of funding for asset origination and for capital efficiency purposes. The loans and advances are transferred by the group to the SEs for cash, and the SEs issue debt securities to investors to fund the cash purchases. The group may also act as a derivative counterparty or provide a guarantee. Credit enhancements to the underlying assets may be provided to obtain investment grade ratings on the senior debt issued by the SEs.

Third-party financing SEs

The group also transacts with third-party SEs in the normal course of business for a number of purposes, for example, to provide finance to public and private sector infrastructure projects, for asset and structured finance transactions and for customers to raise finance against security. The group also has interests in third-party established structured entities by holding notes issued by these entities or entering into derivatives where the group absorbs risk from the entities.

Funds

The group has established and managed funds to provide customers with investment opportunities. The group, as the fund manager, may be entitled to receive management and performance fees based on the assets under management. The group purchases and holds units of HSBC managed and third-party managed funds in order to facilitate both business and customer needs. The majority of these funds held relate to the insurance business. When the group is deemed to be acting as a principal rather than an agent in its role as a fund manager, the group controls and hence consolidates these funds.

The group's transactions with consolidated SEs are not significant.

Unconsolidated structured entities

The maximum exposure to loss from the group's interests in unconsolidated SEs represents the maximum loss that the group could incur as a result of its involvement with unconsolidated SEs regardless of the probability of the loss being incurred. For commitments and guarantees, the maximum exposure to loss is the notional amount of potential future losses. For retained and purchased investments in and loans to unconsolidated SEs, the maximum exposure to loss is the carrying value of these interests at the balance sheet reporting date. The maximum exposure to loss is stated gross of the effects of hedging and collateral arrangements entered into to mitigate the group's exposure to loss.

The nature and risk associated with the group's interest in unconsolidated SEs are set out below.

	Securitisations	HSBC managed funds	Non-HSBC managed funds	Other	Total
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
At 31 Dec 2017					
Total assets	169,139	684,898	6,003,678	39,478	6,897,193
The group's interest – assets					
Trading assets	–	874	–	–	874
Financial assets designated at fair value	–	26,016	44,463	–	70,479
Derivatives	1	–	–	–	1
Loans and advances to customers	20,200	–	–	8,281	28,481
Financial investments	–	1,270	391	–	1,661
Other assets	–	–	–	297	297
Total assets in relation to the group's interests in the unconsolidated structured entities ¹	20,201	28,160	44,854	8,578	101,793
The group's interest – liabilities					
Derivatives	–	–	–	–	–
Total liabilities in relation to the group's interests in the unconsolidated structured entities	–	–	–	–	–
The group's maximum exposure	20,219	28,160	51,119	11,698	111,196
At 31 Dec 2016					
Total assets	33,137	567,991	5,784,647	59,374	6,445,149
The group's interest – assets					
Trading assets	–	2,272	–	–	2,272
Financial assets designated at fair value	–	18,161	44,926	–	63,087
Derivatives	–	–	–	249	249
Loans and advances to customers	6,786	–	–	7,568	14,354
Financial investments	–	–	797	–	797
Other assets	–	–	–	358	358
Total assets in relation to the group's interests in the unconsolidated structured entities ¹	6,786	20,433	45,723	8,175	81,117
The group's interest – liabilities					
Derivatives	–	–	–	1	1
Total liabilities in relation to the group's interests in the unconsolidated structured entities	–	–	–	1	1
The group's maximum exposure	7,305	20,434	53,097	8,532	89,368

¹ Most of HSBC managed funds and non-HSBC managed funds are held by the insurance business.

Structured entities sponsored by the group

The amount of assets transferred to unconsolidated structured entities sponsored by the group during 2017 and 2016 was not significant.

39 Bank balance sheet and statement of changes in equity

Bank balance sheet at 31 December 2017

	2017 HK\$m	2016 HK\$m
Assets		
Cash and sight balances at central banks	149,529	163,204
Items in the course of collection from other banks	19,172	15,006
Hong Kong Government certificates of indebtedness	267,174	242,194
Trading assets	354,114	274,287
Derivatives	281,552	453,746
Financial assets designated at fair value	463	403
Reverse repurchase agreements – non-trading	203,031	146,398
Placings with and advances to banks	187,495	202,763
Loans and advances to customers	1,832,490	1,575,340
Financial investments	796,384	983,049
Amounts due from Group companies	486,744	450,399
Investments in subsidiaries	89,418	81,801
Interests in associates and joint ventures	39,830	39,830
Goodwill and intangible assets	5,542	4,578
Property, plant and equipment	83,520	82,344
Deferred tax assets	738	530
Prepayments, accrued income and other assets	87,287	108,001
Total assets	4,884,483	4,823,873
Liabilities		
Hong Kong currency notes in circulation	267,174	242,194
Items in the course of transmission to other banks	28,217	25,350
Repurchase agreements – non-trading	12,243	10,464
Deposits by banks	154,728	139,033
Customer accounts	3,179,845	3,100,506
Trading liabilities	101,529	100,777
Derivatives	289,649	440,528
Financial liabilities designated at fair value	7,838	8,917
Debt securities in issue	27,865	18,255
Retirement benefit liabilities	1,675	2,914
Amounts due to Group companies	337,344	272,210
Accruals and deferred income, other liabilities and provisions	51,929	53,779
Current tax liabilities	1,099	1,119
Deferred tax liabilities	8,758	7,625
Subordinated liabilities	3,126	3,102
Preference shares	20,930	26,779
Total liabilities	4,493,949	4,453,552
Equity		
Share capital	151,360	114,359
Other equity instruments	14,737	14,737
Other reserves	18,855	8,443
Retained earnings	205,582	232,782
Total equity	390,534	370,321
Total equity and liabilities	4,884,483	4,823,873

Bank statement of changes in equity for the year ended 31 December 2017

	Other reserves								Total equity
	Share capital	Other equity instruments	Retained earnings	Property revaluation reserve	Available-for-sale investment reserve	Cash flow hedge reserve	Foreign exchange reserve	Other ¹	
	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m	HK\$m
At 1 Jan 2017	114,359	14,737	232,782	35,816	2,262	(675)	(13,734)	(15,226)	370,321
Profit for the year	—	—	62,511	—	—	—	—	—	62,511
Other comprehensive income/expense (net of tax)	—	—	707	7,252	(538)	557	4,261	—	12,239
– available-for-sale investments	—	—	—	—	(538)	—	—	—	(538)
– cash flow hedges	—	—	—	—	—	557	—	—	557
– changes in fair value of financial liabilities designated at fair value arising from changes in own credit risk ²	—	—	(205)	—	—	—	—	—	(205)
– property revaluation	—	—	—	7,252	—	—	—	—	7,252
– actuarial gains on defined benefit asset/liability	—	—	912	—	—	—	—	—	912
– exchange differences	—	—	—	—	—	—	4,261	—	4,261
Total comprehensive income/(expense) for the year	—	—	63,218	7,252	(538)	557	4,261	—	74,750
Shares issued	1,744	—	—	—	—	—	—	—	1,744
Dividends paid ³	—	—	(56,260)	—	—	—	—	—	(56,260)
Movement in respect of share-based payment arrangements	—	—	(103)	—	—	—	—	(311)	(414)
Transfers and other movements ^{4,6}	35,257	—	(34,055)	(3,269)	(36)	—	—	2,496	393
At 31 Dec 2017	151,360	14,737	205,582	39,799	1,688	(118)	(9,473)	(13,041)	390,534
At 1 Jan 2016	96,052	14,737	214,938	33,056	1,355	19	(12,867)	(15,005)	332,285
Profit for the year	—	—	59,314	—	—	—	—	—	59,314
Other comprehensive income/expense (net of tax)	—	—	573	4,082	913	(694)	(867)	—	4,007
– available-for-sale investments	—	—	—	—	913	—	—	—	913
– cash flow hedges	—	—	—	—	—	(694)	—	—	(694)
– property revaluation	—	—	(173)	4,082	—	—	—	—	3,909
– actuarial gains on defined benefit asset/liability	—	—	746	—	—	—	—	—	746
– exchange differences	—	—	—	—	—	—	(867)	—	(867)
Total comprehensive income/(expense) for the year	—	—	59,887	4,082	913	(694)	(867)	—	63,321
Shares issued	18,307	—	—	—	—	—	—	—	18,307
Dividends paid ³	—	—	(43,296)	—	—	—	—	—	(43,296)
Movement in respect of share-based payment arrangements	—	—	205	—	—	—	—	(215)	(10)
Transfers and other movements	—	—	1,048	(1,322)	(6)	—	—	(6)	(286)
At 31 Dec 2016	114,359	14,737	232,782	35,816	2,262	(675)	(13,734)	(15,226)	370,321

For footnotes, please refer to page 50.

40 Legal proceedings and regulatory matters

The group is party to legal proceedings and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described below, the Bank considers that none of these matters are material. The recognition of provisions is determined in accordance with the accounting policies set out in note 1.2(j). While the outcome of legal proceedings and regulatory matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of these matters as at 31 December 2017. Any provision recognised does not constitute an admission of wrongdoing or legal liability. It is not practicable to provide an aggregate estimate of potential liability for our legal proceedings and regulatory matters as a class of contingent liabilities.

Anti-money laundering and sanctions-related matters

In October 2010, HSBC Bank USA entered into a consent cease and desist order with the Office of the Comptroller of the Currency (the 'OCC') and the indirect parent of that company, HSBC North America Holdings Inc. ('HNAH'), entered into a consent cease and desist order with the US Federal Reserve Board. In 2012, HSBC Bank USA further entered into an enterprise-wide compliance consent order (together the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including risk management related to the US Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. While these Orders remain open, HSBC Bank USA and HNAH believe that they have taken appropriate steps to bring themselves into compliance with the requirements of the Orders.

In December 2012, HSBC Holdings plc, HNAH and HSBC Bank USA entered into agreements with US and UK government and regulatory agencies regarding past inadequate compliance with the BSA, AML and sanctions laws. Among those agreements, HSBC Holdings plc and HSBC Bank USA entered into a five-year deferred prosecution agreement with, among others, the US Department of Justice ('DoJ') (the 'AML DPA'); and HSBC Holdings plc consented to a cease-and-desist order and HSBC Holdings plc and HNAH consented to a civil money penalty order with the Federal Reserve Board. HSBC Holdings plc also entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions, as well as an undertaking with the UK Financial Conduct Authority to comply with certain forward-looking AML and sanctions-related obligations. In addition, HSBC Bank

Notes on the Consolidated Financial Statements

USA entered into civil money penalty orders with the Financial Crimes Enforcement Network of the US Treasury Department and the OCC.

Under these agreements, HSBC Holdings plc and HSBC Bank USA made payments totalling US\$1.9bn to US authorities and undertook various further obligations, including, among others, to retain an independent compliance monitor (who is, for Financial Conduct Authority ('FCA') purposes, a 'skilled person' under section 166 of the Financial Services and Markets Act) to produce annual assessments of the Group's AML and sanctions compliance programme (the 'Monitor'). Under the cease and desist order issued by the Federal Reserve Board ('FRB') in 2012, the Monitor also serves as an independent consultant to conduct annual assessments. In February 2018, the Monitor delivered his fourth annual follow-up review report.

Through his country-level reviews, the Monitor identified potential anti-money laundering and sanctions compliance issues that HSBC is reviewing further with the DoJ, Federal Reserve Board and/or Financial Conduct Authority. In particular, the DoJ is investigating HSBC's handling of a corporate customer's accounts. In addition, the Financial Crimes Enforcement Network of the US Treasury Department, as well as the Civil Division of the US Attorney's Office for the Southern District of New York are investigating the collection and transmittal of third-party originator information in certain payments instructed over HSBC's proprietary payment systems. HSBC is cooperating with all of these investigations.

In December 2017, the AML DPA expired and the charges deferred by the AML DPA were dismissed. The Monitor will continue working in his capacity as a skilled person and independent consultant for a period of time at the FCA's and FRB's discretion.

Concurrent with entry into the AML DPA, HSBC Bank USA also entered into two consent orders with the OCC. The first, discussed above, required HSBC Bank USA to adopt an enterprise-wide compliance programme. The second required HSBC Bank USA to correct the circumstances noted in the OCC's report and imposed restrictions on HSBC Bank USA acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, without the OCC's prior approval.

These settlements with US and UK authorities have led to private litigation, and do not preclude further private litigation related to HSBC's compliance with applicable BSA, AML and sanctions laws or other regulatory or law enforcement actions for BSA, AML, sanctions or other matters not covered by the various agreements.

Tax investigations

The Bank continues to cooperate with the relevant US and other authorities, including with respect to clients of the Bank in India who may have had US tax reporting obligations.

In addition, various tax administration, regulatory and law enforcement authorities around the world, including in India, are conducting investigations and reviews of HSBC Swiss Private Bank and other HSBC companies in connection with allegations of tax evasion or tax fraud, money laundering and unlawful cross-border banking solicitation. In February 2015, the Indian tax authority issued a summons and request for information to the Bank in India.

The Bank and other HSBC companies are cooperating with the relevant authorities. There are many factors that may affect the range of outcomes, and the resulting financial impact, of these investigations and reviews, which could be significant.

In light of the media attention regarding these matters, it is possible that other tax administration, regulatory or law enforcement authorities will also initiate or enlarge similar investigations or regulatory proceedings.

Mossack Fonseca & Co.

HSBC has received requests for information from various regulatory and law enforcement authorities around the world concerning persons and entities believed to be linked to Mossack Fonseca & Co., a service provider of personal investment companies. HSBC is cooperating with the relevant authorities.

Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of this matter, including the timing or any possible impact on HSBC, which could be significant.

Singapore Interbank Offered Rate ('SIBOR'), Singapore Swap Offer Rate ('SOR') and Australia Bank Bill Swap Rate ('BBSW')

In July 2016 and August 2016, HSBC and other panel banks were named as defendants in two putative class actions filed in the New York District Court on behalf of persons who transacted in products related to the SIBOR, SOR and BBSW benchmark rates. The complaints allege, among other things, misconduct related to these benchmark rates in violation of US antitrust, commodities and racketeering laws, and state law. In August 2017, the defendants moved to dismiss the SIBOR and SOR case, and this motion remains pending. The defendants moved to dismiss the BBSW case in February 2017 and this motion also remains pending. There are many factors that may affect the range of outcomes, and the resulting financial impact, of these matters, which could be significant.

Foreign exchange rate investigations

Various regulators and competition and law enforcement authorities around the world, including in South Korea, are conducting civil and criminal investigations and reviews into trading by HSBC and others on the foreign exchange markets. The Bank and other HSBC companies are cooperating with these investigations and reviews.

In August 2016, the DoJ indicted two now-former HSBC employees and charged them with wire fraud and conspiracy relating to a 2011 foreign exchange transaction. In October 2017, one of the former employees was found guilty after trial. In January 2018, HSBC Holdings plc entered into a three-year deferred prosecution agreement with the Criminal Division of the DoJ (the 'FX DPA'), regarding fraudulent conduct in connection with two particular transactions in 2010 and 2011. This concluded the DoJ's investigation into HSBC's historical foreign exchange activities. Under the terms of the FX DPA, HSBC has a number of ongoing obligations, including continuing to cooperate with authorities and implementing enhancements to its internal controls and procedures in its Global Markets business, which will be the subject of annual reports to the DoJ. In addition, HSBC agreed to pay a financial penalty and restitution.

There are many factors that may affect the range of outcomes and the resulting financial impact of these investigations, which could be significant.

Hiring practices investigation

The US Securities and Exchange Commission (the 'SEC') is investigating multiple financial institutions, including HSBC Holdings plc, in relation to hiring practices of candidates referred by or related to government officials or employees of state-owned enterprises in Asia-Pacific. HSBC has received various requests for information and is cooperating with the SEC's investigation.

Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of this matter, including the timing or any possible impact on HSBC, which could be significant.

41 Ultimate holding company

The ultimate holding company of the Bank is HSBC Holdings plc, which is incorporated in England.

The largest group in which the accounts of the Bank are consolidated is that headed by HSBC Holdings plc. The consolidated accounts of HSBC Holdings plc are available to the public on the HSBC Group's website at www.hsbc.com or may be obtained from 8 Canada Square, London E14 5HQ, United Kingdom.

42 Events after the balance sheet date

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

43 Approval of financial statements

The financial statements were approved and authorised for issue by the Board of Directors on 20 February 2018.

© The Hongkong and Shanghai Banking Corporation Limited 2018

Printed by Asia One Printing Limited, Hong Kong, on Revive 100 Offset board and paper using vegetable oil-based inks. Made in Austria, the paper comprises 100% de-inked post-consumer waste. Pulps used are totally chlorine-free.

The FSC™ logo identifies products which contain wood derived from responsible forests certified in accordance with the rules of the Forest Stewardship Council®.



The Hongkong and Shanghai Banking Corporation Limited

HSBC Main Building
1 Queen's Road Central, Hong Kong
Telephone: (852) 2822 1111
Facsimile: (852) 2810 1112
www.hsbc.com.hk