

BANK OF COMMUNICATIONS (HONG KONG) LIMITED

(Incorporated in Hong Kong with limited liability)

Annual Report 2018



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Bank of Communications (Hong Kong) Limited

20 Pedder Street, Central, Hong Kong

www.hk.bankcomm.com

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Report of the Directors

The directors submit their report with the audited financial statements for the year ended 31 December 2018.

Principal activities

The principal activity of the Company is provision of banking services.

Results and appropriations

The results of the Company for the year are set out in the statement of profit or loss and other comprehensive income on page 7.

The directors do not recommend the payment of a dividend in respect of the year ended 31 December 2018.

Business Review

No business review is presented for the year ended 31 December 2018 as the Company has been able to claim an exemption under section 388 (3)(b) of the Companies Ordinance (Cap. 622) since it is a wholly-owned subsidiary of Bank of Communications Co. Ltd.

Donations

There are no charitable and other donations made by the Company during the years ended 31 December 2018 and 2017.

Shares issued in the year

Details of the share issued in the year ended 31 December 2018 are set out in Note 30 to the financial statements.

Directors of the Company

The directors during the year and up to the date of this report were:

Chairman:

Wang Feng (appointed on 27 February 2019)

Shou Fugang (resigned on 27 February 2019)

Executive directors:

Chan Ha Fong, Nancy

Meng Yu

Cheng Man Wang

Non-executive directors:

Zhang Hui (appointed on 28 June 2018)

Zhu Chen (appointed on 28 June 2018)

Independent non-executive directors:

Lam Cheung Alexa (resigned on 30 September 2018)

Chan Ka Lok

Tang Kwai Chang

Report of the Directors

Directors of the Company *(Continued)*

Zhang Hui and Zhu Chen are non-executive directors of the Company. Lam Cheung Alexa resigned on 30 September 2018 as independent non-executive director of the Company and Shou Fugang resigned on 27 February 2019 as Chairman and executive director of the Company. Lam Cheung Alexa and Shou Fugang have confirmed that they have no disagreement with the Board and nothing relating to the affairs of the Company needed to be brought to the attention of the shareholders of the Company.

In accordance with the Company's Articles of Association, the existing directors except Wang Feng shall remain in the office.

Pursuant to Articles 24.2, 24.5 and 25 of the Company's Articles of Association, Wang Feng will retire and, being eligible to offer himself for re-election as director of the Company at the forthcoming Annual General Meeting.

Directors' material interests in transactions, arrangements and contracts that are significant in relation to the Company's business

No transactions, arrangements and contracts of significance in relation to the Company's business to which the Company's fellow subsidiaries or its holding company was a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

Directors' interests in the shares and debentures of the Company or any specified undertaking of the Company

At no time during the year was the Company, its fellow subsidiaries or its holding company or its other associated corporations a party to any arrangement to enable the directors of the Company to (including their spouse and children under 18 years of age) hold any interests in the shares or debentures of, the Company or its specified undertakings or other associated corporations.

Management contracts

No contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.

Permitted indemnity provisions

Pursuant to the Company's Articles of Association, a director or former director of the Company may be indemnified out of the Company's assets against any liability incurred by the director to a person other than the Company or an associated company of the Company in connection with any negligence, default, breach of duty or breach of trust in relation to the Company or associated company. The Company has arranged appropriate directors' and officers' liability insurance for the directors and officers of the Company during the year and up to the date of the Report of the Directors.

Auditor

The financial statements for the year ended 31 December 2018 have been audited by PricewaterhouseCoopers, who retire and, being eligible, offer themselves for re-appointment.

On behalf of the Board

Wang Feng, *Chairman*

Hong Kong, 3 April 2019

Independent Auditor's Report

TO THE MEMBER OF BANK OF COMMUNICATIONS (HONG KONG) LIMITED

(Incorporated in Hong Kong with limited liability)

Opinion

What we have audited

The financial statements of Bank of Communications (Hong Kong) Limited (the "Company") set out on pages 7 to 117, which comprise:

- the statement of financial position as at 31 December 2018;
- the statement of profit or loss and other comprehensive income for the year then ended;
- the statement of changes in equity for the year then ended;
- the statement of cash flows for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies.

Our opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Company as at 31 December 2018, and of its financial performance and its 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 ("HKSAAs") issued by the HKICPA. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the 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 Company 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.

Independent Auditor's Report

Other Information

The directors are responsible for the other information. The other information comprises the information included in the annual report, but does not include the financial statements and our auditor's report thereon.

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

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

If, based on the work we have performed, 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.

Responsibilities of Directors and the Audit Committee for the Financial Statements

The directors are responsible for the preparation of the 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 financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company'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 Company or to cease operations, or have no realistic alternative but to do so.

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

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the 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 financial statements.

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

- Identify and assess the risks of material misstatement of the 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.

Independent Auditor's Report

Auditor's Responsibilities for the Audit of the Financial Statements *(Continued)*

- 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 Company'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 Company'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 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 Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

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.

PricewaterhouseCoopers
Certified Public Accountants

Hong Kong, 3 April 2019

Statement of Profit or Loss and Other Comprehensive Income

(All amounts expressed in thousands of HK\$ unless otherwise stated)

		Year ended 31 December	
		2018	2017 (restated)
	Notes		
Interest income		4,814,092	12,827,339
Interest expense		(2,957,265)	(7,767,152)
Net interest income	4	1,856,827	5,060,187
Fee and commission income	5	777,684	1,743,825
Fee and commission expense	6	(45,028)	(84,521)
Net fee and commission income		732,656	1,659,304
Net gains arising from trading activities	8	366,822	785,411
Net (losses)/gains arising from financial investments		(9,851)	146,716
Dividend income	7	700	2,980
Other operating income	9	20,982	110,189
Change in expected credit losses	10	(212,589)	N.A.
Charges on impairment allowances	10	N.A.	(101,858)
Other operating expenses	11	(1,503,772)	(2,431,715)
Profit before tax		1,251,775	5,231,214
Income tax expenses	14	(268,758)	(838,036)
Net profit for the year		983,017	4,393,178
Other comprehensive income for the year, net of tax			
<i>Item that will not be reclassified subsequently to profit or loss</i>			
<i>Equity investments at fair value through other comprehensive income – net change in fair value</i>		1,816	N.A.
<i>Items that may be reclassified to profit or loss:</i>			
<i>Available-for-sale financial assets</i>			
<i>Changes in fair value recorded in equity</i>		N.A.	441,472
<i>Changes in fair value reclassified from equity to profit or loss</i>		N.A.	(147,192)
<i>Net (losses)/gains arising from cash flow hedge</i>			
<i>Changes in fair value recorded in equity</i>		(529)	25,098
<i>Changes in fair value reclassified from equity to profit or loss</i>		–	(2,655)
<i>Debt investments at fair value through other comprehensive income</i>			
<i>Net gains recorded in equity</i>		221,146	N.A.
<i>Net gains reclassified from equity to profit or loss</i>		(19,367)	N.A.
Other comprehensive income for the year		203,066	316,723
Total comprehensive income for the year		1,186,083	4,709,901

The accompanying notes form a part of these financial statements.

Statement of Financial Position

(All amounts expressed in thousands of HK\$ unless otherwise stated)

		As at 31 December	
		2018	2017 (restated)
	<i>Notes</i>		
ASSETS			
Cash and balances with central bank	15	2,353,780	2,615,265
Due from banks and other financial institutions	16	25,082,437	105,855,209
Loans and advances to customers	19	67,688,719	256,368,508
Financial assets at fair value through profit or loss	17	1,855,354	20,290,313
Financial investments – financial assets at fair value through other comprehensive income	20	109,315,062	N.A.
Financial investments – available-for-sale	20	N.A.	182,454,457
Financial investments – held-to-maturity	20	N.A.	3,895,864
Property and equipment	21	67,418	391,446
Deferred income tax assets	22	10,978	11,352
Other assets	23	1,502,974	5,559,800
Total assets		207,876,722	577,442,214
LIABILITIES			
Due to banks and other financial institutions	24	21,126,951	21,108,085
Financial liabilities at fair value through profit or loss	25	467,764	11,055,199
Due to customers	26	162,074,683	439,788,233
Certificates of deposit issued	27	–	22,014,718
Debt securities issued	28	–	38,888,667
Current tax liabilities		151,997	943,915
Other liabilities	29	5,422,094	6,499,466
Total liabilities		189,243,489	540,298,283
EQUITY			
Head office account		–	18,380,966
Share capital	30	17,900,000	300,000
Other reserves		86,974	931,049
Retained earnings		646,259	17,531,916
Total equity		18,633,233	37,143,931
Total equity and liabilities		207,876,722	577,442,214

The financial statements were approved and authorized for issuance by the Board of Directors on 3 April 2019 and signed on its behalf by:

Wang Feng, Chairman

Chan Ha Fong, Nancy, Chief Executive

The accompanying notes form a part of these financial statements.

Statement of Changes in Equity

(All amounts expressed in thousands of HK\$ unless otherwise stated)

	Attributable to the shareholder of the Company					Total
	Head office account	Share capital	Revaluation reserve	Cash flow hedge reserve (Note 18)	Retained earnings (Note (a))	
At 1 January 2018	–	300,000	–	–	(7,512)	292,488
Effect of recapitalization of a business	18,380,966	–	940,348	(9,299)	17,539,428	36,851,443
	18,380,966	300,000	940,348	(9,299)	17,531,916	37,143,931
Change in accounting policy	–	–	54,957	–	(101,009)	(46,052)
Restated balance at 1 January 2018	18,380,966	300,000	995,305	(9,299)	17,430,907	37,097,879
Net profit for the year	–	–	–	–	983,017	983,017
Other comprehensive income	–	–	203,595	(529)	–	203,066
Repayment to Head office	(18,380,966)	–	–	–	–	(18,380,966)
Issuance of share capital	–	17,600,000	–	–	–	17,600,000
Transfer of Excluded Business to HKBR (Note 2)	–	–	(1,111,926)	9,828	(17,767,665)	(18,869,763)
At 31 December 2018	–	17,900,000	86,974	–	646,259	18,633,233
At 1 January 2017	–	300,000	–	–	(1,720)	298,280
Effect of recapitalization of a business	(16,786,699)	–	646,068	(31,742)	13,140,458	(3,031,915)
Restated balance at 1 January 2017	(16,786,699)	300,000	646,068	(31,742)	13,138,738	(2,733,635)
Net profit for the year	–	–	–	–	4,393,178	4,393,178
Other comprehensive income	–	–	294,280	22,443	–	316,723
Proceeds from Head office	35,167,665	–	–	–	–	35,167,665
At 31 December 2017 (restated)	18,380,966	300,000	940,348	(9,299)	17,531,916	37,143,931

Note (a):

In accordance with the requirements of the Hong Kong Monetary Authority (the "HKMA"), the regulatory reserve is set aside for general banking risks, including future losses or other unforeseeable risks. The regulatory reserve is set up in compliance with the HKMA's requirements and is distributable to shareholder of the Company subject to consultation with the HKMA. As at 31 December 2018, HK\$794,919,000 (2017: HK\$963,336,000) was earmarked as the regulatory reserve from the retained earnings.

The accompanying notes form a part of these financial statements.

Statement of Cash Flows

(All amounts expressed in thousands of HK\$ unless otherwise stated)

	Year ended 31 December	
	2018	2017 (restated)
	<i>Notes</i>	
Cash flows from operating activities:		
Profit before tax	1,251,775	5,231,214
Adjustments for:		
Change in expected credit losses	212,589	N.A.
Charges on impairment allowances	N.A.	101,858
Depreciation and amortization	33,154	87,865
Loss on disposal of property and equipment	2,183	–
Interest income from financial investments	(2,200,059)	(5,370,233)
Fair value losses	11,788	335,799
Dividend income	(700)	(2,980)
Withholding tax	59,363	–
Revaluation surplus of investment properties	–	(48,520)
Net losses/(gains) arising from financial investments	9,851	(146,716)
Interest expenses on certificates of deposit issued and debt securities issued	119,347	1,268,292
Operating cash flows before movements in operating assets and liabilities	(500,709)	1,456,579
Net decrease/(increase) in due from banks and other financial institutions	16,117,318	(18,996,780)
Net decrease in financial assets at fair value through profit or loss	1,159,657	1,470,930
Net increase in loans and advances to customers	(13,904,519)	(26,517,836)
Net increase in other assets	(8,744,712)	(906,245)
Net increase/(decrease) in due to banks and other financial institutions	205,313,139	(27,405,453)
Net increase/(decrease) in financial liabilities at fair value through profit or loss	2,037,834	(2,839,785)
Net increase in due to customers	22,324,403	86,016,438
Net increase in other liabilities	97,482,278	560,967
Income tax (paid)/refund	(997,878)	765,875
Net cash inflows from operating activities	320,286,811	13,604,690

Statement of Cash Flows

(All amounts expressed in thousands of HK\$ unless otherwise stated)

		Year ended 31 December	
		2018	2017 (restated)
	<i>Notes</i>		
Cash flows from investing activities:			
Purchase of financial investments		(211,897,275)	(72,204,282)
Disposal or redemption of financial investments		38,076,566	36,322,585
Dividend received		700	2,980
Interest received from financial investments		2,545,279	4,913,588
Purchase of property and equipment		(26,135)	(75,738)
Purchase of intangible assets		(1,523)	–
Net cash outflows from investing activities		(171,302,388)	(31,040,867)
Cash flows from financing activities:			
Proceeds from debt securities and certificate of deposits issued		567,236	37,092,136
Repayment of debt securities and certificate of deposits issued (Repayment to)/proceeds from Head office		(6,039,343)	(20,181,693)
Interest paid for certificates of deposit issued and debt securities issued		(305,432)	(1,134,299)
Proceeds from issuance of share capital		17,600,000	–
Net cash (outflows)/inflows from financing activities		(6,558,505)	50,943,809
Net increase in cash and cash equivalents		142,425,918	33,507,632
Transfer of cash and cash equivalents in relation to the Transfer of Excluded Business to HKBR	2	(171,312,689)	–
Cash and cash equivalents at the beginning of the year		40,591,761	7,084,129
Cash and cash equivalents at the end of the year	32	11,704,990	40,591,761
Net cash flows from operating activities include:			
Interest received		3,161,720	7,162,478
Interest paid		(2,945,396)	(6,331,062)

The accompanying notes form a part of these financial statements.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

1 GENERAL

Bank of Communications (Hong Kong) Limited (“the Company”) is a private company incorporated and domiciled in Hong Kong. The address of its registered office is 20 Pedder Street, Central, Hong Kong and principal place of business is 1/F, Wheelock House, 20 Pedder Street, Central, Hong Kong. Its ultimate holding company is Bank of Communications Co., Ltd., which is incorporated in the People’s Republic of China.

On 29 September 2015, the Monetary Authority granted the Company a banking licence under the Banking Ordinance.

On 29 January 2018 (the “Appointed Day”), the Bank of Communications (Hong Kong) Limited (Merger) Ordinance (Chapter 1182 of the laws of Hong Kong) (the “Ordinance”) has become effective. Pursuant to the Ordinance, certain activities, assets and liabilities which constitute the retail banking business and private banking business (“Transferred Business”) of Bank of Communications Co., Ltd. Hong Kong Branch (“HKBR”) have been transferred to the Company in accordance with section 4 (1) of the Ordinance. Accordingly, the Company commenced its retail banking business and private banking business on the Appointed Day.

These financial statements are presented in thousands of Hong Kong Dollars (HK\$), unless otherwise stated.

The financial information for HKBR for the year ended 31 December 2017 has not been audited or reviewed.

The regulatory disclosure information required under the Banking (Disclosure) Rules is available in the Regulatory Disclosure Section of our website www.hk.bankcomm.com.

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

2.1 Basis of preparation

These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (“HKFRSs”) and the requirements of the Hong Kong Companies Ordinance (Cap. 622). The financial statements have been prepared on the historical cost basis except for certain financial instruments and investment properties which are measured at fair value.

The Company adopts the going concern basis in preparing its financial statements.

The transfer of retail bank business and private banking business from HKBR to the Company is a recapitalization of a business and does not result in any changes in business substance, management nor the ultimate controlling shareholder. Accordingly, the assets and liabilities of the Transferred Business have been presented using their carrying value in the records of HKBR.

Certain assets and liabilities of HKBR’s corporate banking business have not been transferred to the Company (the “Excluded Business”). Accordingly, the statement of financial position and the statement of comprehensive income of the Company includes the net assets and results of the Excluded Business up to 28 January 2018 because the results of this business cannot be clearly distinguished from that of the Transferred Business. The Excluded Business have been accounted for as a deduction from equity upon completion of the business transfer at 29 January 2018.

The effects of all transactions between the Company and the HKBR before the recapitalization are eliminated in preparing the financial statements.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.1 Basis of preparation *(continued)*

The effects of the recapitalization of a business for the year ended 31 December 2018 and 2017, are summarized below.

The financial position of the Company at 31 December 2017:

	HKBR	The Company	Inter- company elimination	Total
ASSETS				
Cash and balances with central bank	2,615,265	300,090	(300,090)	2,615,265
Due from banks and other financial institutions	105,855,209	–	–	105,855,209
Loans and advances to customers	256,368,508	–	–	256,368,508
Financial assets at fair value through profit or loss	20,290,313	–	–	20,290,313
Financial investments – available-for-sale	182,454,457	–	–	182,454,457
Financial investments – held-to-maturity	3,895,864	–	–	3,895,864
Property and equipment	391,446	–	–	391,446
Deferred income tax assets	11,352	–	–	11,352
Other assets	5,556,669	3,131	–	5,559,800
Total assets	577,439,083	303,221	(300,090)	577,442,214
LIABILITIES				
Due to banks and other financial institutions	21,099,015	9,070	–	21,108,085
Financial liabilities at fair value through profit or loss	11,055,199	–	–	11,055,199
Due to customers	440,088,323	–	(300,090)	439,788,233
Certificates of deposit issued	22,014,718	–	–	22,014,718
Current tax liabilities	943,915	–	–	943,915
Debt securities issued	38,888,667	–	–	38,888,667
Other liabilities	6,497,803	1,663	–	6,499,466
Total liabilities	540,587,640	10,733	(300,090)	540,298,283
EQUITY				
Head office account	18,380,966	–	–	18,380,966
Share capital	–	300,000	–	300,000
Other reserves	931,049	–	–	931,049
Retained earnings/(accumulated losses)	17,539,428	(7,512)	–	17,531,916
Total equity	36,851,443	292,488	–	37,143,931
Total equity and liabilities	577,439,083	303,221	(300,090)	577,442,214

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.1 Basis of preparation *(continued)*

The statement of comprehensive income for the year ended 31 December 2018:

	HKBR	The Company	Total
Net interest income	277,569	1,579,258	1,856,827
Other income	392,069	719,240	1,111,309
Total income	669,638	2,298,498	2,968,136
Operating expenses	(158,983)	(1,344,789)	(1,503,772)
Change in expected credit losses	(47,672)	(164,917)	(212,589)
Profit before tax	462,983	788,792	1,251,775
Income tax	(133,774)	(134,984)	(268,758)
Profit for the year	329,209	653,808	983,017
Other comprehensive income	116,092	86,974	203,066
Total comprehensive income for the year	445,301	740,782	1,186,083

The statement of comprehensive income for the year ended 31 December 2017:

	HKBR	The Company	Total
Net interest income	5,060,157	30	5,060,187
Other income	2,704,600	–	2,704,600
Total income	7,764,757	30	7,764,787
Operating expenses	(2,425,893)	(5,822)	(2,431,715)
Charges on impairment allowance	(101,858)	–	(101,858)
Profit/(loss) before tax	5,237,006	(5,792)	5,231,214
Income tax	(838,036)	–	(838,036)
Profit/(loss) for the year	4,398,970	(5,792)	4,393,178
Other comprehensive income	316,723	–	316,723
Total comprehensive income/(expense) for the year	4,715,693	(5,792)	4,709,901

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

2.1 Basis of preparation (continued)

2.1.1 New and revised HKFRSs effective by 1 January 2018 applied by the Company

HKFRS 9	Financial Instruments
HKFRS 15 and the related amendments	Revenue from Contracts with Customers
HK(IFRIC)-Int 22	Foreign Currency Transactions and Advance Consideration
Amendments to HKAS 28 and HKFRS 1	As part of the Annual Improvements to HKFRSs 2014-2016 Cycle
Amendments to HKAS 40	Transfers of Investment Property

The impact of the adoption of Hong Kong Financial Reporting Standard (“HKFRS”) 9 is disclosed in note 2.2.1 below. The other standards did not have any material impact on the Company’s accounting policies and did not require retrospective adjustments.

2.1.2 Standards and amendments that are not yet effective and have not been adopted by the Company

		Effective for annual period beginning on or after
HKFRIC 23	Uncertainty over income tax	1 January 2019
HKFRS 16	Leases	1 January 2019
Amendments to HKFRS 9	Prepayment Features with Negative Compensation and Modifications of Financial Liabilities	1 January 2019

HKFRS 16 Leases

HKFRS 16 was issued in January 2016. It will result in almost all leases being recognized on the statement of financial position by lessees, as the distinction between operating and finance leases is removed. Under the new standard, an asset (the right to use the leased item) and a financial liability to pay rentals are recognized. The only exceptions are short-term and low-value leases.

General Affairs Department has reviewed all of the Company’s leasing arrangements over the last year in light of the new lease accounting rules in HKFRS 16. The standard will affect primarily the accounting for the Company’s operating leases. As at 31 December 2018, certain lease agreements have been signed by HKBR which the leases are used by the Company and the rental expenses are incurred by the Company. The Company will recognize the right-of-use assets and lease liability. The implementation is not expected to have significant impact on total assets and total liabilities.

The Company’s activities as a lessor are not material and hence the Company does not expect any significant impact on the financial statements. However, some additional disclosures will be required from next year.

The Company will apply the standard from its mandatory adoption date of 1 January 2019. The Company intends to apply the simplified transition approach and will not restate comparative amounts for the year prior to first adoption. Right-of-use assets for property leases will be measured on transition as if the new rules had always been applied. All other right-of-use assets will be measured at the amount of the lease liability on adoption (adjusted for any prepaid or accrued lease expenses).

Except for the above mentioned impact of HKFRS 16, the adoption of the above new HKFRSs and amendments to HKFRSs issued but not yet effective is not expected to have a material effect on the Company’s operating results, financial position or other comprehensive income.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Changes in accounting policies

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption

HKFRS 9 replaces the provisions of HKAS 39 that relate to the recognition, classification and measurement of financial assets and financial liabilities, derecognition of financial instruments, impairment of financial assets and hedge accounting.

The adoption of HKFRS 9 Financial Instruments from 1 January 2018 resulted in changes in accounting policies and adjustments to the amounts recognized in the financial statements. The new accounting policies are set out in note 2.3.4 below. In accordance with the transitional provisions in HKFRS 9, comparative figures have not been restated with the exception of certain aspects of hedge accounting.

The total impact on the Company's retained earnings as at 1 January 2018 is as follows:

		2018
	<i>Notes</i>	
Closing retained earnings 31 December 2017 – HKAS 39		16,568,580
Increase in expected credit loss (2017: provision for impairment allowance) on financial investments – financial assets at fair value through other comprehensive income	(iv)	(87,321)
Decrease in expected credit loss (2017: provision for impairment allowance) on loans and advances to customers	(iv)	124,977
Increase in expected credit loss (2017: provision for impairment allowance) on financial assets at amortized cost	(iv)	(41,395)
Increase in expected credit loss on financial guarantee and credit related commitments		(112,828)
The change in fair value of non-derivative financial liability designated at fair value arising from the changes in the liability's own credit risk	(i)(e)	7,703
The reclassification from available-for-sale to fair value through profit or loss	(i)(a)	7,855
Adjustment to retained earnings from adoption of HKFRS 9 on 1 January 2018		(101,009)
Opening retained earnings 1 January 2018 – HKFRS 9		16,467,571

Notes to the Financial Statements

For the year ended 31 December 2018

(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Changes in accounting policies *(continued)*

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption *(continued)*

(i) Classification and measurement

On 1 January 2018 (the date of initial application of HKFRS 9), the Company's management has assessed which business models to be applied to the financial assets held by the Company and has classified its financial instruments into the appropriate HKFRS 9 categories. The measurement category and the carrying amounts of financial assets in accordance with HKAS 39 and HKFRS 9 as at 1 January 2018 are compared as follows:

	31 Dec 2017	Reclassifications	Remeasurements	01 Jan 2018 (Restated)
Financial assets				
Cash and balances with central bank	2,615,265	–	–	2,615,265
Due from banks and other financial institutions	105,855,209	–	(28,284)	105,826,925
Financial assets at fair value through profit or loss	20,290,313	838,116	–	21,128,429
Loans and advance to customers	256,368,508	–	124,977	256,493,485
Financial investments – financial assets at fair value through other comprehensive income	N.A.	181,616,341	(16,806)	181,599,535
Financial investments – available-for-sale	182,454,457	(182,454,457)	–	N.A.
Financial investments – amortized cost	N.A.	3,895,864	(4,951)	3,890,913
Financial investments – held-to-maturity	3,895,864	(3,895,864)	–	N.A.
Other financial assets	5,008,562	–	(8,160)	5,000,402
Subtotal	576,488,178	–	66,776	576,554,954

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Changes in accounting policies *(continued)*

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption *(continued)*

(i) Classification and measurement (continued)

The impact of these changes on the Company's equity is as follows:

		Revaluation Reserve		
		Effect on AFS reserve	Effect on fair value through other comprehensive income reserve	Effect on retained earnings
	<i>Notes</i>			
Closing balance 31 December 2017 – HKAS 39		931,049	–	16,568,580
Reclassify investment from available-for-sale to fair value through profit or loss	(a)	(7,855)	–	7,855
Reclassify non-trading equities from available-for sale to fair value through other comprehensive income	(b)	–	(16,806)	–
Reclassify listed and unlisted bonds from available-for-sale to fair value through other comprehensive income	(d)	(923,194)	923,194	–
Reclassify the change in fair value of non-derivative financial liability designated at fair value arising from the changes in its own credit risk	(e)	–	(7,703)	7,703
Total impact		(931,049)	898,685	15,558
Opening balance 1 January 2018 – HKFRS 9		–	898,685	16,584,138

Notes to the Financial Statements

For the year ended 31 December 2018

(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Changes in accounting policies *(continued)*

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption *(continued)*

(i) Classification and measurement (continued)

a. Reclassification from available-for-sale to fair value through profit or loss

Certain investment in debt securities were reclassified from available-for-sale to financial assets at fair value through profit or loss (HK\$838,116,000 as at 1 January 2018). They do not meet the HKFRS 9 criteria for classification at amortized cost, because their contractual cash flows do not represent solely payments of principal and interest.

Related fair value gains of HK\$7,855,000 were transferred from the available-for-sale financial assets reserve to retained earnings on 1 January 2018.

b. Equity investment previously classified as available-for-sale

The Company elected to present in other comprehensive income the changes in the fair value of all its equity investments previously classified as available-for-sale, because these investments are held as long-term strategic investments that are not expected to be sold in the short to medium term. The equity investment was measured at cost previously. With the adoption of HKFRS 9, the equity investment was remeasured at fair value of HK\$19,968,000 and the amount was transferred from available-for-sale to fair value through other comprehensive income and fair value loss of HK\$16,806,000 was recorded in other comprehensive income.

c. Reclassification from held-to-maturity to amortized cost

Debt securities that would have previously been classified as held-to maturity are now classified at amortized cost. The Company intends to hold the assets to maturity to collect contractual cash flows and these cash flows consist solely of payments of principal and interest on the principal amount outstanding. There was no difference between the previous carrying amount and the revised carrying amount of the other financial assets at 1 January 2018.

d. Available-for-sale debt instruments classified as fair value through other comprehensive income

Listed and unlisted bonds were reclassified from available-for-sale to fair value through other comprehensive income, as the Company's business model is achieved by both collecting contractual cash flows and selling of these assets. The contractual cash flows of these investments are solely principal and interest. As a result, listed and unlisted bonds with a fair value of HK\$181,579,567,000 were reclassified from available-for-sale financial assets to financial assets at fair value through other comprehensive income and fair value gains of HK\$923,194,000 were reclassified from the available-for-sale reserve to the fair value through other comprehensive income reserve on 1 January 2018.

e. Non-derivative financial liabilities

Following the adoption of HKFRS 9, the changes in fair value of the certificate of deposits issued and debt securities issued by the Company due to the change in the liability's own credit rating are recognized in other comprehensive income. As a result, the amount of HK\$7,703,000 was reclassified from retained earnings to fair value through other comprehensive income reserve on 1 January 2018.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

2.2 Changes in accounting policies (continued)

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption (continued)

(ii) Reconciliation of statement of financial position balances from HKAS 39 to HKFRS 9

The following table reconciles the carrying amounts of financial assets, from their previous measurement category in accordance with HKAS 39 to their new measurement categories upon transition to HKFRS 9 on 1 January 2018:

	HKAS 39 carrying amount 31 Dec 2017	Reclassifications	Remeasurements	HKFRS 9 carrying amount 01 Jan 2018 (Restated)
<i>Notes</i>				
At Amortized Cost				
<i>Cash and balances with central bank</i>				
Opening balance under HKAS 39 and closing balance under HKFRS 9	2,615,265	–	–	2,615,265
<i>Due from banks and other financial institutions</i>				
Opening balance under HKAS 39	105,855,209	–	–	–
Remeasurement: ECL allowance (iv)	–	–	(28,284)	–
Closing balance under HKFRS 9	–	–	–	105,826,925
<i>Other financial assets</i>				
Opening balance under HKAS 39	5,008,562	–	–	–
Remeasurement: ECL allowance (iv)	–	–	(8,160)	–
Closing balance under HKFRS 9	–	–	–	5,000,402
<i>Loans and advances to customers</i>				
Opening balance under HKAS 39	256,368,508	–	–	–
Remeasurement: ECL allowance for loans and advances to customers (iv)	–	–	124,977	–
Closing balance under HKFRS 9	–	–	–	256,493,485
<i>Financial investments – held-to-maturity</i>				
Opening balance under HKAS 39	3,895,864	–	–	–
Subtraction: To financial investments – financial assets at amortized cost (i)(c)	–	(3,895,864)	–	–
Closing balance under HKFRS 9	–	–	–	N.A.
<i>Financial investments – amortized cost</i>				
Opening balance under HKAS 39	N.A.	–	–	–
Addition: From financial investments – held-to-maturity (HKAS 39) (i)(c)	–	3,895,864	–	–
Remeasurement: ECL allowance (iv)	–	–	(4,951)	–
Closing balance under HKFRS 9	–	–	–	3,890,913
Total financial assets at amortized cost	373,743,408	–	83,582	373,826,990

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

2.2 Changes in accounting policies (continued)

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption (continued)

(ii) Reconciliation of statement of financial position balances from HKAS 39 to HKFRS 9 (continued)

		HKAS 39 carrying amount			HKFRS 9 carrying amount
		31 Dec 2017	Reclassifications	Remeasurements	01 Jan 2018 (Restated)
	Notes				
At fair value through profit or loss					
<i>Financial assets at fair value through profit and loss</i>					
Opening balance under HKAS 39		20,290,313	–	–	–
Addition: From available-for-sale debt instruments (HKAS 39)	(i)(a)	–	838,116	–	–
Closing balance under HKFRS 9		–	–	–	21,128,429
		20,290,313	838,116	–	21,128,429
At fair value through other comprehensive income (FVOCI)					
<i>Financial investments – available-for-sale</i>					
Opening balance under HKAS 39		182,454,457	–	–	–
Subtraction: To financial investments – fair value through other comprehensive income-debt instruments	(i)(d)	–	(181,579,567)	–	–
Subtraction: To financial investments – fair value through other comprehensive income-equity instruments	(i)(b)	–	(36,774)	–	–
Subtraction: To financial assets at fair value through profit and loss	(i)(a)	–	(838,116)	–	–
Closing balance under HKFRS 9		–	–	–	N.A.
<i>Financial investments – financial assets at fair value through other comprehensive income</i>					
Opening balance under HKAS 39		N.A.	–	–	–
Addition: From financial investments – available-for-sale debt instruments	(i)(d)	–	181,579,567	–	–
Addition: From financial investments – available-for-sale equity instruments	(i)(b)	–	36,774	(16,806)	–
Closing balance under HKFRS 9		–	–	–	181,599,535
<i>Total financial investments – financial assets measured at fair value through other comprehensive income</i>		182,454,457	(838,116)	(16,806)	181,599,535
Total		576,488,178	–	66,776	576,554,954

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Changes in accounting policies *(continued)*

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption *(continued)*

(iii) Derivatives and hedging activities

The Company's risk management strategies and hedge documentation of currency forward, currency and interest rate swaps and currency and interest rate options are aligned with the requirements of HKFRS 9 and these relationships are therefore treated as continuing hedges. Therefore, the management considers there are no material impacts for the Company's derivatives instruments with the adoption of HKFRS 9.

(iv) Impairment of financial assets

The Company has four types of financial assets that are subject to HKFRS 9's new expected credit loss model:

- loans and advances to customers;
- financial investment – amortized cost;
- other financial assets; and
- debt investment carried at fair value through other comprehensive income

The Company was required to revise its impairment methodology under HKFRS 9 for each of these classes of assets. The impact of the change in impairment methodology on the Company's retained earnings and equity is disclosed in the table in note 2.2.1 above.

Loans and advances to customers

The Company applies the HKFRS 9 to measure expected credit losses for all loans and advances to customers.

To measure the expected credit losses, loans and advances to customers have been grouped based on the shared credit risk characteristics.

On that basis, the loss allowance as at 1 January 2018 was determined as follows for loans and advances to customers:

	2018 ECL staging				2017 (restated)
	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total	Total
Gross carrying amount	253,945,174	3,263,468	556,902	257,765,544	257,765,544
Loss allowance	(921,191)	(63,681)	(287,187)	(1,272,059)	(1,397,036)
Carrying amount	253,023,983	3,199,787	269,715	256,493,485	256,368,508

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Changes in accounting policies *(continued)*

2.2.1 HKFRS 9 Financial Instruments – Impact of adoption *(continued)*

(iv) Impairment of financial assets (continued)

The loss allowances for loans and advances to customers as at 31 December 2017 are reconciled to the opening loss allowances on 1 January 2018 as follows:

	Loans and advances to customers
At 31 December 2017 – calculated under HKAS 39 (restated)	1,397,036
Amount restated through opening retained earnings	(124,977)
Opening loss allowance as at 1 January 2018 – calculated under HKFRS 9	<u>1,272,059</u>

The Company's policy requires the review of individual financial assets that have objective evidence of impairment at least semi-annually or more regularly when individual circumstances require. Impairment allowances on individually assessed financial assets are determined at the reporting date on a case-by-case basis, and are applied to all individually impaired financial assets. The assessment normally encompasses collaterals held (including re-confirmation of its enforceability) and the anticipated cash flows from that individual asset.

Other financial assets at amortized cost

Other financial assets at amortized cost include due from banks and other financial institutions, financial investment at amortised cost and other receivables. Applying the expected credit risk model resulted in the recognition of a loss allowance of HK\$41,395,000 on 1 January 2018.

While cash and cash equivalents are also subject to the impairment requirement of HKFRS 9, the identified impairment loss was immaterial.

Debt investments at fair value through other comprehensive income

The restatement of the loss allowance for debt investments at fair value through other comprehensive income on transition to HKFRS 9 as a result of applying the expected credit risk model was HK\$87,321,000. HK\$87,321,000 has been reclassified from revaluation reserve to retained earnings.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies

2.3.1 Interest income and expense

Interest income and expense are recognized in profit or loss for interest-bearing financial instruments using the effective interest method.

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (including a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant periods. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Company estimates cash flows considering all contractual terms of the financial instrument (but does not consider future credit losses). The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Interest income on an impaired financial asset or a group of impaired similar financial assets is recognized using the original interest rate which was used to discount the future cash flows for the purpose of measuring the impairment loss.

2.3.2 Fee and commission income

The Company earns fee and commission income from a diverse range of services it provides to its customers. For those services that are over a period of time, fee and commission income are accrued over that period when the services are rendered. For other services, fee and commission income are recognized when the services are rendered.

2.3.3 Dividend income

Dividends are recognized when the right to receive the dividends is established.

2.3.4 Financial assets and liabilities

Measurement methods

Initial recognition and measurement

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of financial assets are recognized on trade-date, the date on which the Company commits to purchase or sell the asset.

At initial recognition, the Company measures a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are incremental and directly attributable to the acquisition or issue of the financial asset or financial liability, such as fees and commissions. Transaction costs of financial assets and financial liabilities carried at fair value through profit or loss are expensed in profit or loss. Immediately after initial recognition, an expected credit loss allowance (ECL) is recognized for financial assets measured at amortized cost and investments in debt instruments measured at FVOCI, which results in an accounting loss being recognized in profit or loss when an asset is newly originated.

When the fair value of financial assets and liabilities differs from the transaction price on initial recognition, the Company recognizes the difference as follows:

- (a) When the fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. a Level 1 input) or based on a valuation technique that uses only data from observable markets, the difference is recognized as a gain or loss.
- (b) In all other cases, the difference is deferred and the timing of recognition of deferred day one profit or loss is determined individually. It is either amortized over the life of the instrument, deferred until the instrument's fair value can be determined using market observable inputs, or realized through settlement.

Notes to the Financial Statements

For the year ended 31 December 2018

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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

Measurement methods (continued)

Amortized cost and effective interest rate

The amortized cost is the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset (i.e. its amortized cost before any impairment allowance) or to the amortized cost of a financial liability. The calculation does not consider expected credit losses and includes transaction costs, premiums or discounts and fees and points paid or received that are integral to the effective interest rate, such as origination fees. For purchased or originated credit-impaired ('POCI') financial assets – assets that are credit-impaired (see definition on note 3.1.2.2) at initial recognition – the Company calculates the credit-adjusted effective interest rate, which is calculated based on the amortized cost of the financial asset instead of its gross carrying amount and incorporates the impact of expected credit losses in estimated future cash flows.

When the Company revises the estimates of future cash flows, the carrying amount of the respective financial assets or financial liability is adjusted to reflect the new estimate discounted cash flows using the original effective interest rate. Any changes are recognized in profit or loss.

Interest income

Interest income is calculated by applying the effective interest rate to the gross carrying amount of financial assets, except for:

- (a) POCI financial assets, for which the original credit-adjusted effective interest rate is applied to the amortized cost of the financial asset.
- (b) Financial assets that are not 'POCI' but have subsequently become credit-impaired (or 'stage 3'), for which interest revenue is calculated by applying the effective interest rate to their amortized cost (i.e. net of the expected credit loss provision).

Notes to the Financial Statements

For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.1 Financial assets

(i) Classification and subsequent measurement

From 1 January 2018, the Company has applied HKFRS 9 and classifies its financial assets in the following measurement categories:

- Fair value through profit or loss;
- Fair value through other comprehensive income; or
- Amortized cost.

The classification requirements for debt and equity instruments are described below:

Debt instruments

Debt instruments are those instruments that meet the definition of a financial liability from the issuer's perspective, such as loans, government and corporate bonds.

Classification and subsequent measurement of debt instruments depend on:

- (i) The Company's business model for managing the asset; and
- (ii) The cash flow characteristics of the asset.

Based on these factors, the Company classifies its debt instruments into one of the following three measurement categories:

- **Amortized cost:** Assets that are held for collection of contractual cash flows where those cash flows represent solely payments of principal and interest ('SPPI'), and that are not designated at fair value through profit or loss, are measured at amortized cost. The carrying amount of these assets is adjusted by any expected credit loss allowance recognized and measured from these financial assets. Interest income from these financial assets is included in 'Interest income' using the effective interest rate method.
- **Fair value through other comprehensive income:** Financial assets that are held for collection of contractual cash flows and for selling the assets, where the assets' cash flows represent solely payments of principal and interest, and that are not designated at fair value through profit or loss, are measured at fair value through other comprehensive income. Movements in the carrying amount are taken through other comprehensive income, except for the recognition of impairment gains or losses, interest revenue and foreign exchange gains and losses on the instrument's amortized cost which are recognized in profit or loss. When the financial asset is derecognized, the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit or loss and recognized in 'Net gains/losses from financial investment'. Interest income from these financial assets is recognized in profit or loss and included in 'Interest income' using the effective interest rate method.
- **Fair value through profit or loss:** Assets that do not meet the criteria for amortized cost or fair value through other comprehensive income are measured at fair value through profit or loss. A gain or loss on a debt investment that is subsequently measured at fair value through profit or loss and is not part of a hedging relationship is recognized in profit or loss and recognized in the profit or loss within 'Net gains/losses arising from trading activities' in the period in which it arises.

Notes to the Financial Statements

For the year ended 31 December 2018

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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.1 Financial assets *(continued)*

(i) Classification and subsequent measurement (continued)

Debt instruments *(continued)*

Business model: the business model reflects how the Company manages the assets in order to generate cash flows. That is, whether the Company's objective is solely to collect the contractual cash flows from the assets or is to collect both the contractual cash flows and cash flows arising from the sale of assets. If neither of these is applicable (e.g. financial assets are held for trading purposes), then the financial assets are classified as part of 'other' business model and measured at fair value through profit or loss. Factors considered by the Company in determining the business model for a Company of assets include past experience on how the cash flows for these assets were collected, how the asset's performance is evaluated and reported to key management personnel, how risks are assessed and managed and how managers are compensated.

SPPI: Where the business model is to hold assets to collect contractual cash flows or to collect contractual cash flows and sell, the Company assesses whether the financial instruments' cash flows represent solely payments of principal and interest (the 'SPPI test'). In making this assessment, the Company considers whether the contractual cash flows are consistent with a basic lending arrangement i.e. interest includes only consideration for the time value of money, credit risk, other basic lending risks and a profit margin that is consistent with a basic lending arrangement. Where the contractual terms introduce exposure to risk or volatility that are inconsistent with a basic lending arrangement, the related financial asset is classified and measured at fair value through profit or loss.

Financial assets with embedded derivatives are considered in their entirety when determining whether their cash flows are solely payment of principal and interest.

The Company reclassifies debt investments when and only when its business model for managing those assets changes. The reclassification takes place from the start of the first reporting period following the change. Such changes are expected to be very infrequent and none occurred during the period.

Equity instruments

Equity instruments are instruments that meet the definition of equity from the issuer's perspective; that is, instruments that do not contain a contractual obligation to pay and that evidence a residual interest in the issuer's net assets. Examples of equity instruments include basic ordinary shares.

The Company subsequently measures all equity investments at fair value through profit or loss, except where the Company's management has elected, at initial recognition, to irrevocably designate an equity investment at fair value through other comprehensive income. The Company's policy is to designate equity investments as fair value through other comprehensive income when those investments are held for purposes other than to sell. When this election is used, fair value gains and losses are recognized in other comprehensive income and are not subsequently reclassified to profit or loss, including on disposal. Dividends, when representing a return on such investments, continue to be recognized in profit or loss as 'Dividend income' when the Company's right to receive payments is established.

Gains and losses on equity investments at fair value through profit or loss are recognized in the profit or loss as 'Net gains/losses arising from trading activities'.

Notes to the Financial Statements

For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.1 Financial assets *(continued)*

(ii) Impairment

The Company assesses on a forward-looking basis the ECL associated with its debt instrument assets carried at amortized cost and fair value through other comprehensive income and with the exposure arising from loan commitments and financial guarantee contracts. The Company recognizes a loss allowance for such losses at each reporting date. The measurement of ECL reflects:

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- The time value of money; and
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Regarding these judgment and estimates, refer to Credit Risk management in Note 3.1. Note 3.1.2 provides details of how the ECL allowance is measured.

(iii) Modification of loans

The Company sometimes renegotiates or otherwise modifies the contractual cash flows of loans to customers. When this happens, the Company assesses whether or not the new terms are substantially different to the original terms. The Company does this by considering, among others, the following factors:

- If the borrower is in financial difficulty, whether the modification merely reduces the contractual cash flows to amounts the borrower is expected to be able to pay.
- Whether any substantial new terms are introduced, such as a profit share/equity-based return that substantially affects the risk profile of the loan.
- Significant extension of the loan term when the borrower is not in financial difficulty.
- Significant change in the interest rate.
- Change in the currency the loan is denominated in.
- Insertion of collateral, other security or credit enhancements that significantly affect the credit risk associated with the loan.

If the terms are substantially different, the Company derecognizes the original financial asset and recognizes a 'new' asset at fair value and recalculates a new effective interest rate for the asset. The date of renegotiation is consequently considered to be the date of initial recognition for impairment calculation purposes, including for the purpose of determining whether a significant increase in credit risk has occurred. However, the Company also assesses whether the new financial asset recognized is deemed to be credit-impaired at initial recognition, especially in circumstances where the renegotiation was driven by the debtor being unable to make the originally agreed payments. Differences in the carrying amount are also recognized in profit or loss as a gain or loss on derecognition.

If the terms are not substantially different, the renegotiation or modification does not result in derecognition, and the Company recalculates the gross carrying amount based on the revised cash flows of the financial asset and recognizes a modification gain or loss in profit or loss. The new gross carrying amount is recalculated by discounting the modified cash flows at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

Notes to the Financial Statements

For the year ended 31 December 2018

(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.1 Financial assets *(continued)*

(iv) Derecognition other than on a modification

Financial assets, or a portion thereof, are derecognized when the contractual rights to receive the cash flows from the assets have expired, or when they have been transferred and either (i) the Company transfers substantially all the risks and rewards of ownership, or (ii) the Company neither transfers nor retains substantially all the risks and rewards of ownership and the Company has not retained control.

The Company enters into transactions where it retains the contractual rights to receive cash flows from assets but assumes a contractual obligation to pay those cash flows to other entities and transfers substantially all of the risks and rewards. These transactions are accounted for as 'pass through' transfers that result in derecognition if the Company:

- (i) Has no obligation to make payments unless it collects equivalent amounts from the assets;
- (ii) Is prohibited from selling or pledging the assets; and
- (iii) Has an obligation to remit any cash it collects from the assets without material delay.

Collateral (shares and bonds) furnished by the Company under standard repurchase agreements and securities lending and borrowing transactions are not derecognized because the Company retains substantially all the risks and rewards on the basis of the predetermined repurchase price, and the criteria for derecognition are therefore not met. This also applies to certain securitization transactions in which the Company retains a subordinated residual interest.

When the contractual rights to receive the cash flows from the assets have been transferred, and the Company neither transfers nor retains substantially all the risks and rewards of ownership, and the Company has retained control of the transferred assets, the Company applies continuing involvement approach. Under this approach, the Company continues to recognize the transferred asset to the extent of its continuing involvement and recognize the associated liability, to reflect the rights and obligations retained by the Company. The net carrying amount of the transferred asset and associated liability is: (a) the amortized cost of the rights and obligations retained by the Company, if the transferred asset is measured at amortized cost; or (b) equal to the fair value of the rights and obligations retained by the Company when measured on a stand-alone basis, if the transferred asset is measured at fair value.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.2 Financial liabilities

(i) Classification and subsequent measurement

In both the current and prior period, financial liabilities are classified as liabilities measured at amortized cost, except for:

- Financial liabilities at fair value through profit or loss: this classification is applied to derivatives, financial liabilities held for trading (e.g. short positions in the trading booking) and other financial liabilities designated as such at initial recognition. Gains or losses on financial liabilities designated at fair value through profit or loss are presented partially in other comprehensive income (the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability, which is determined as the amount that is not attributable to changes in market conditions that give rise to market risk) and partially profit or loss (the remaining amount of change in the fair value of the liability). This is unless such a presentation would create, or enlarge, an accounting mismatch, in which case the gains and losses attributable to changes in the credit risk of the liability are also presented in profit or loss;
- Financial liabilities arising from the transfer of financial assets which did not qualify for derecognition or when the continuing involvement approach applies. When the transfer of financial asset did not qualify for derecognition, a financial liability is recognized for the consideration received for the transfer. In subsequent periods, the Company recognizes any expense incurred on the financial liability; when continuing involvement approach applies, see note 2.3.4.1 (iv); and
- Financial guarantee contracts and loan commitments (see note 2.3.5).

(ii) Derecognition

Financial liabilities are derecognized when they are extinguished (i.e. when the obligation specified in the contract is discharged, cancelled or expires).

The exchange between the Company and its original lenders of debt instruments with substantially different terms, as well as substantial modifications of the terms of existing financial liabilities, are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is more than 10% different from the discounted present value of the remaining cash flows of the original financial liability. In addition, other qualitative factors, such as the currency that the instrument is denominated in, changes in the type of interest rate, new conversion features attached to the instrument and change in covenants are also taken into consideration. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognized as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.

Notes to the Financial Statements

For the year ended 31 December 2018

(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.3 Accounting policies applied until 31 December 2017

The Company has applied HKFRS 9 retrospectively, but has elected not to restate comparative information. As a result, the comparative information provided continues to be accounted for in accordance with the Company's previous accounting policy.

2.3.4.3.1 Financial assets

Until 31 December 2017, the Company's financial assets are initially measured at fair value and classified into one of the four categories, including financial assets at fair value through profit or loss, held-to-maturity investments, available-for-sale financial assets and loans and receivables. Financial investments comprise held-to-maturity investments, available-for-sale financial assets and debt securities classified as loans and receivables. All regular way purchases or sales of financial assets are recognized and derecognized on a trade date basis. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the time frame established by regulation or convention in the market place.

(a) Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss have two subcategories, including financial assets held for trading and those designated at fair value through profit or loss on initial recognition.

A financial asset is classified as held for trading if one of the following conditions is satisfied: (1) It has been acquired principally for the purpose of selling in the near term; or (2) On initial recognition it is part of a portfolio of identified financial instruments that the Company manages together and there is objective evidence that the Company has a recent actual pattern of short-term profit-taking; or (3) It is a derivative, except for a derivative that is designated and effective as a hedging instrument, or a financial guarantee contract, or a derivative that is linked to and must be settled by delivery of an unquoted equity instrument (without a quoted price in an active market) whose fair value cannot be reliably measured.

A financial asset may be designated as at fair value through profit or loss upon initial recognition only when one of the following conditions is satisfied: (1) Such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise result from measuring assets or recognizing the gains or losses on them on different bases; or (2) The financial asset forms part of a group of financial assets or a group of financial assets and financial liabilities, which is managed and its performance is evaluated on a fair value basis, in accordance with the Company's documented risk management or investment strategy, and information about the grouping is reported to key management personnel on that basis; or (3) It forms part of a contract containing one or more embedded derivatives, and HKAS 39 – Financial Instruments: Recognition and Measurement permits the entire combined contract(asset or liability) to be designated at financial assets at fair value through profit or loss.

Financial assets at fair value through profit or loss are subsequently measured at fair value. Any gains or losses arising from changes in the fair value and any dividend or interest income earned on the financial assets are recognized in profit or loss.

(b) Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Company has the positive intention and ability to hold to maturity. Subsequent to initial recognition, held-to-maturity investments are measured at amortized cost using the effective interest method, less any identified impairment losses.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.3 Accounting policies applied until 31 December 2017 *(continued)*

2.3.4.3.1 Financial assets *(continued)*

(c) Available-for-sale financial assets

Available-for-sale financial assets are non-derivative that are not either designated or classified as financial assets at fair value through profit or loss, loans and receivables or held-to-maturity investments.

Available-for-sale financial assets are measured at fair value at the end of the reporting period. Changes in fair value are recognized in other comprehensive income, until the financial asset is disposed of or is determined to be impaired, at which time, the cumulative gain or loss previously recognized in other comprehensive income accumulated at which time in equity is reclassified to profit or loss.

For available-for-sale equity investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, they are measured at cost less any identified impairment losses at the end of the reporting period.

Dividends on available-for-sale equity instruments are recognized in profit or loss when the Company's right to receive the dividends is established.

Interest income on available-for-sale debt instruments are calculated using the effective interest method and recognized in profit or loss.

(d) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Subsequent to initial recognition, loans and receivables are carried at amortized cost using the effective interest method, less any identified impairment losses.

2.3.4.3.2 Impairment of financial assets

Financial assets, other than those at fair value through profit or loss, are assessed for indicators of impairment at the end of the reporting period. Financial assets are considered to be impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the financial assets have been affected.

Objective evidence of impairment of financial assets could include the following observable events:

- (1) Significant financial difficulty of the issuer or obligor.
- (2) A breach of contract, such as a default or delinquency in interest or principal payments.
- (3) The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider.
- (4) It becoming probable that the borrower will enter bankruptcy or other financial reorganization.
- (5) The disappearance of an active market for that financial asset because of financial difficulties.
- (6) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including: adverse changes in the payment status of borrowers in the group; and national or local economic conditions that correlate with defaults on the assets in the group.

Notes to the Financial Statements

For the year ended 31 December 2018

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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.3 Accounting policies applied until 31 December 2017 *(continued)*

2.3.4.3.2 Impairment of financial assets *(continued)*

(7) Any significant change with an adverse effect that has taken place in the technological, market, economic or legal environment in which the issuer operates and indicates that the cost of investments in equity instruments may not be recovered.

(8) A significant or prolonged decline in the fair value of equity instrument investments; and

(9) Other objective evidence indicating impairment of the financial asset.

(a) Impairment of financial assets carried at amortized cost

For a financial asset that is individually significant, the Company assesses the asset individually for impairment. For a financial asset that is not individually significant, the Company assesses the asset individually for impairment or includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. If the Company determines that no objective evidence of impairment exists for an individually assessed financial asset (whether significant or not), it includes the asset in a group of financial assets with similar credit risk characteristics and collectively reassesses them for impairment. Assets for which an impairment loss is individually recognized are not included in a collective assessment of impairment.

If financial assets carried at amortized cost are impaired, the carrying amounts of the financial assets are reduced to the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The amount of reduction is recognized as an impairment loss in profit or loss and is recorded through the use of an allowance account. When a financial asset is considered uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are credited to profit or loss. If, subsequent to the recognition of an impairment loss on financial assets carried at amortized cost, there is objective evidence of a recovery in value of the financial assets which can be related objectively to an event occurring after the impairment is recognized, the previously recognized impairment loss is reversed. However, the reversal is made to the extent that the carrying amount of the financial asset at the date the impairment is reversed does not exceed what the amortized cost would have been had the impairment not been recognized.

(b) Impairment of available-for-sale financial assets

For available-for-sale equity instruments, a significant or prolonged decline in fair value below cost is considered to be objective evidence of impairment.

When an available-for-sale financial asset is impaired, the cumulative loss arising from decline in fair value previously recognized directly in other comprehensive income is reclassified to profit or loss. The cumulative loss reclassified is the balance of the initial acquisition cost of the asset deducted by the recovered principal, amortized amount, the current fair value, and the impairment loss that has been previously recorded in profit or loss.

If, subsequent to the recognition of an impairment loss on available-for-sale financial assets, there is objective evidence of a recovery in value of the financial assets which can be related objectively to an event occurring after the impairment is recognized, the previously recognized impairment loss is reversed. The amount of reversal of impairment loss on available-for-sale equity instruments is recognized as other comprehensive income, while the amount of reversal of impairment loss on available-for-sale debt investments is recognized in profit or loss.

Notes to the Financial Statements

For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.3 Accounting policies applied until 31 December 2017 *(continued)*

2.3.4.3.2 Impairment of financial assets *(continued)*

(c) Impairment of financial assets measured at cost

If an impairment loss has been incurred on an investment in unquoted equity instrument (without a quoted price in an active market) whose fair value cannot be reliably measured, or on a derivative financial asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the carrying amount of the financial asset is reduced to the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. The amount of reduction is recognized as an impairment loss in profit or loss. The impairment loss on such financial asset is not reversed once it is recognized.

2.3.4.3.3 Financial liabilities

All financial liabilities are initially measured at fair value and classified either as financial liabilities at fair value through profit or loss or other financial liabilities.

(a) Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss consist of financial liabilities held for trading and those designated as at fair value through profit or loss on initial recognition. A financial liability is classified as held for trading if one of the following conditions is satisfied: (1) It has been acquired principally for the purpose of repurchasing in the near term; or (2) On initial recognition it is part of a portfolio of identified financial instruments that the Company manages together and there is objective evidence that the Company has a recent actual pattern of short-term profit-taking; or (3) It is a derivative, except for a derivative that is a designated and effective hedging instrument, or a financial guarantee contract, or a derivative that is linked to and must be settled by delivery of an unquoted equity instrument (without a quoted price in an active market) whose fair value cannot be reliably measured.

A financial liability may be designated as at fair value through profit or loss upon initial recognition only when one of the following conditions is satisfied: (1) Such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise result from measuring liabilities or recognising the gains or losses on them on different bases; or (2) The financial liability forms part of a group of financial liabilities or a group of financial assets and financial liabilities, which is managed and its performance is evaluated on a fair value basis, in accordance with the Company's documented risk management or investment strategy, and information about the grouping is reported to key management personnel on that basis; or (3) It forms part of a contract containing one or more embedded derivatives, and HKAS 39 – Financial Instruments: Recognition and Measurement permits the entire combined contract (asset or liability) to be designated at financial liabilities at fair value through profit or loss.

Financial liabilities at fair value through profit or loss are subsequently measured at fair value. Any gains or losses arising from changes in the fair value or any interest expenses related to the financial liabilities are recognized in profit or loss.

(b) Other financial liabilities

For a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument (without a quoted price in an active market) whose fair value cannot be reliably measured, it is subsequently measured at cost. Other financial liabilities are subsequently measured at amortized cost using the effective interest method, with gain or losses arising from de-recognition or amortization recognized in profit or loss.

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For the year ended 31 December 2018

(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.4 Financial assets and liabilities *(continued)*

2.3.4.3 Accounting policies applied until 31 December 2017 *(continued)*

2.3.4.3.3 Financial liabilities *(continued)*

(c) De-recognition of financial liabilities

The Company derecognizes a financial liability or part of it only when the underlying present obligation or part of it is discharged, cancelled or expired. An agreement between the Company (an existing borrower) and an existing lender to replace the original financial liability with a new financial liability with substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

When the Company derecognizes a financial liability or a part of it, it recognizes the difference between the carrying amount of the financial liability derecognized and the consideration paid and payable (including any non-cash assets transferred or new financial liabilities assumed) in profit or loss.

2.3.5 Financial guarantee contracts and loan commitments

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Such financial guarantees are given to banks, financial institutions and others on behalf of customers to secure loans, overdrafts and other banking facilities.

Financial guarantee contracts are initially measured at fair value and subsequently measured at the higher of:

- The amount of the loss allowance; and
- The premium received on initial recognition less income recognized in accordance with the principles of HKFRS 15.

Loan commitments provided by the Company are measured as the amount of the loss allowance. The Company has not provided any commitment to provide loans at a below-market interest rate, or that can be settled net in cash or by delivering or issuing another financial instrument.

For loan commitments and financial guarantee contracts, the loss allowance is recognized as provision. However, for contracts that include both a loan and an undrawn commitment and the Company cannot separately identify the expected credit losses on the undrawn commitment component from those on the loan component, the expected credit losses on the undrawn commitment are recognized together with the loss allowance for the loan. To the extent that the combined expected credit losses exceed the gross carrying amount of the loan, the expected credit losses are recognized as a provision.

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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.6 Derivatives and hedging activities

2.3.6.1 Accounting policy effective from 1 January 2018

The Company has elected to apply the hedge accounting requirements of HKFRS 9.

The Company has not provided comparative information for periods before the date of initial application of HKFRS 9 for the new disclosures introduced by HKFRS 9 as a consequential amendment to HKFRS 7, as permitted by HKFRS 7 paragraph 44Z.

Derivatives are initially recognized at fair value on the date on which the derivative contract is entered into and are subsequently remeasured at fair value. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

Certain derivatives are embedded in hybrid contracts, such as the conversion option in a convertible bond. If the hybrid contract contains a host that is a financial asset, then the Company assesses the entire contract as described in the financial assets section above for classification and measurement purposes. Otherwise, the embedded derivatives are treated as separate derivatives when:

- (i) Their economic characteristics and risks are not closely related to those of the host contract;
- (ii) A separate instrument with the same terms would meet the definition of a derivative; and
- (iii) The hybrid contract is not measured at fair value through profit or loss.

These embedded derivatives are separately accounted for at fair value, with changes in fair value recognized in the statement of profit or loss unless the Company chooses to designate the hybrid contracts at fair value through profit or loss.

The method of recognizing the resulting fair value gain or loss depends on whether the derivative is designated and qualifies as a hedging instrument, and if so, the nature of the item being hedged. The Company designates certain derivatives as either:

- (a) Hedges of the fair value of recognized assets or liabilities or a firm commitment (fair value hedges) or
- (b) Hedges of highly probable future cash flows attributable to a recognized asset or liability (cash flow hedges)

At the inception of the hedging, the Company documents the economic relationship between hedging instruments and hedged items. The Company documents its risk management objective and strategy for undertaking its hedge transactions. The Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

The fair values of derivative financial instruments designated in hedge relationships are disclosed in note 18. Movements in the hedging reserve in shareholder's equity are shown in statement of changes in equity.

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For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.6 Derivatives and hedging activities *(continued)*

2.3.6.1 Accounting policy effective from 1 January 2018 *(continued)*

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the statement of profit or loss, together with changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortized to profit or loss over the period to maturity and recorded as net interest income.

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognized in other comprehensive income. The gain or loss relating to the ineffective portion is recognized immediately in the statement of profit or loss.

Amounts accumulated in equity are recycled to the statement of profit or loss in the periods when the hedged item affects profit or loss. They are recorded in the income or expense lines in which the revenue or expense associated with the related hedged item is reported.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognized in the periods when the hedged item affects profit or loss. When a forecast transaction is no longer expected to occur (for example, the recognized hedged asset is disposed of), the cumulative gain or loss previously recognized in other comprehensive income is immediately reclassified to the statement of profit or loss.

Certain derivative instruments do not qualify for hedge accounting. Changes in the fair value of any derivative instrument that does not qualify for hedge accounting are recognized immediately in profit or loss and are included in gains/(losses) from trading activities.

2.3.6.2 Accounting policy applied until 31 December 2017

(a) Derivative financial instruments

Derivative financial instruments include, but not limited to, interest rate derivative and foreign exchange derivative. Derivative financial instruments are initially measured at fair value at the date a derivative contract is entered into and are subsequently measured at fair value. Changes in fair value of these derivative financial instruments are recognized in profit or loss. Fair values are obtained from quoted market prices in active market or are determined using valuation techniques, including discounted cash flow model and options pricing model as appropriate. All derivatives are recognized as assets when the fair value is positive and as liabilities when the fair value is negative.

Derivatives embedded in non-derivative host contracts are treated as separate derivatives when their characteristics and risks are not closely related to those of the host contracts and the host contracts are not measured at fair value with changes in fair value recognized in profit or loss. These embedded derivatives are separately accounted for at fair value, with changes in fair value recognized in profit or loss.

Notes to the Financial Statements

For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.6 Derivatives and hedging activities *(continued)*

2.3.6.2 Accounting policy applied until 31 December 2017 *(continued)*

(b) Hedge accounting

The Company designates certain derivatives as hedging instruments for fair value hedges or cash flow hedges.

At the inception of the hedge relationship, the Company documents the relationship between the hedging instrument and the hedged item, along with its risk management objectives and its strategy for undertaking various hedge transactions.

Furthermore, at the inception of the hedge and on an ongoing basis, the Company documents whether the hedging instrument is highly effective in offsetting changes in fair values of the hedged item attributable to the hedged risk.

Fair value hedges

Fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

The changes in fair value of hedging instruments that are designated and qualified as fair value hedges are recorded in profit or loss, together with the changes in fair value of the hedged item attributable to the hedged risk. The net difference is recognized as ineffectiveness in the profit or loss.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortized to profit or loss over the period to maturity. If the hedged item is de-recognized, the unamortized carrying value adjustment is recognized immediately in the profit or loss.

Cash flow hedge

Cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction that could ultimately affect the profit or loss.

The effective portion of changes in the fair value of hedging instruments that are designated and qualify as cash flow hedges is recognized in other comprehensive income and accumulated in equity in the reserve. The ineffective portion is recognized immediately in the profit or loss.

Amounts accumulated in equity are reclassified to the profit or loss in the same periods when the hedged item affects the profit or loss.

When a hedging instrument expires or is sold, or the hedge designation is revoked or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss on the hedging instrument existing in equity at that time remains in equity and is reclassified to the profit or loss when the forecast transaction ultimately occurs. When a forecast transaction is no longer expected to occur, the cumulative gain or loss existing in equity is immediately transferred to the profit or loss.

2.3.7 Assets transferred under repurchase agreements

Financial assets sold subject to agreements with a commitment to repurchase at a specific future date at a fixed or determinable price are not derecognized in the statement of financial position. The proceeds from selling such assets are presented under "due to banks and other financial institutions" in the statement of financial position. The difference between the selling price and repurchasing price is recognized as interest expense during the term of the agreement using the effective interest method.

Notes to the Financial Statements

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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.8 Property and equipment

The Company's property and equipment mainly comprise buildings, equipment, transportation equipment and property improvement.

The assets purchased are initially measured at acquisition cost.

Subsequent expenditures incurred for the property and equipment are included in the cost of the property and equipment if it is probable that economic benefits associated with the asset will flow to the Company and the subsequent expenditures can be measured reliably. Meanwhile the carrying amount of the replaced part is derecognized. Other subsequent expenditures are recognized in profit or loss in the period in which they are incurred.

Depreciation is calculated on the straight-line method to write down the cost of such assets over their estimated useful lives. The useful lives of assets are reviewed, and adjusted if appropriate, at each financial reporting date.

Buildings comprise primarily branch office premises and office premises. The estimated useful lives and depreciation rate of buildings, equipment, transportation equipment and property improvement are as follows:

Type of assets	Estimated useful lives
Buildings	50 years
Equipment	5 years
Transportation equipment (excluding equipment under operating leases)	3 years
Property improvement	Over the shorter of the economic useful lives and remaining lease terms

An item of property and equipment is derecognized upon disposal or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on the disposal or retirement of an item of property and equipment is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognized in profit or loss.

2.3.9 Repossessed assets

Repossessed assets are initially recognized at lower of fair value less cost to sell or amortized cost of the corresponding debt at the date of repossession and included in other assets. At each reporting date, repossessed assets are subsequently measured at lower of fair value less cost to sell and the carrying amount. When the fair value less cost to sell is lower than the carrying amount, an impairment loss is recognized in profit or loss.

When a repossessed asset is disposed, the difference between the disposal proceeds and the carrying amount is recognized in profit or loss.

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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.10 Investment property

Investment property is a property held to earn rentals or for capital appreciation or both and initially measured at cost.

As there is an active property market in the location in which the Company's investment property is situated, and the Company can obtain the market price and other relevant information regarding the same or similar type of property from the property market so as to reasonably estimate the fair value of the investment property; therefore, the Company uses the fair value model for subsequent measurement of the investment property, with changes in the fair value included in profit or loss for the period in which they arise.

When an investment property is sold, transferred, retired or damaged, the Company recognizes the amount of any proceeds on disposal net of the carrying amount and related taxes in profit or loss for the period.

2.3.11 Intangible assets

An intangible asset is measured initially at cost. When an intangible asset with a finite useful life is available for use, its original cost is amortized over its estimated useful life using the straight-line method. An intangible asset with an indefinite useful life is not amortized.

For an intangible asset with a finite useful life, the Company reviews the useful life and amortization method at the end of each reporting period, and makes adjustments when necessary.

An intangible asset is derecognized on disposal, or when no future economic benefits are expected from use or disposal. Gains and losses arising from de-recognition of an intangible asset, measured as the difference between the net disposal proceeds and the carrying amount of the asset, are recognized in profit or loss when the asset is derecognized.

2.3.12 Impairment of non-financial assets

At the end of the reporting period or whenever there is an indication that the non-financial assets are impaired, the Company reviews the carrying amounts of its tangible and intangible assets with finite useful lives to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any. If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. An impairment loss is recognized in profit or loss immediately.

Intangible assets with indefinite useful life are tested for impairment annually, irrespective of whether there is any indication that the assets may be impaired.

Where an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but the increased carrying amount should not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset in prior years. A reversal of an impairment loss is recognized in profit or loss immediately.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.13 Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

(a) The Company as lessor

Rental income from operating leases is recognized in profit or loss on a straight-line basis over the term of the relevant lease. Initial direct costs incurred in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and recognized as an expense on a straight-line basis over the lease term.

(b) The Company as lessee

Operating lease payments are recognized as an expense on a straight-line basis over the lease term. Contingent rentals arising under operating leases are recognized as an expense in the period in which they are incurred.

In the event that lease incentives are received to enter into operating leases, such incentives are recognized as a liability. The aggregate benefit of incentives is recognized as a reduction of rental expense on a straight-line basis over the lease term.

2.3.14 Cash and cash equivalents

Cash and cash equivalents are assets with a maturity of less than 3 months from the date of acquisition or highly liquid assets with an original maturity of less than three months, which are readily convertible into known amounts of cash and subject to an insignificant risk of changes in value.

2.3.15 Provisions

Provisions are recognized when the Company has a present obligation related to a contingency, it is probable that an outflow of economic benefits will be required to settle the obligation, and the amount of the obligation can be measured reliably.

The amount recognized as a provision is the best estimate of the consideration required to settle the present obligation at the reporting date, taking into account factors pertaining to a contingency such as the risks, uncertainties and time value of money. Where the effect of the time value of money is material, the amount of the provision is determined by discounting the related future cash outflows.

Where all or some of the expenditure required to settle a provision is expected to be reimbursed by a third party, the reimbursement is recognized as a separate asset only when it is virtually certain that reimbursement will be received, and the amount of reimbursement recognized does not exceed the carrying amount of the provision.

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For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.16 Current and deferred income taxes

Income tax expense represents the sum of the tax currently payable and deferred tax.

(a) Current income tax

The tax currently payable is based on taxable profit for the year. Taxable profit differs from profit as reported in the statement of profit or loss and other comprehensive income because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the end of the reporting period.

(b) Deferred income tax

Deferred tax is recognized on temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax base used in the computation of taxable profit. Deferred tax liabilities are generally recognized for all taxable temporary differences. Deferred tax assets are generally recognized for all deductible temporary difference to the extent that it is probable that taxable profits will be available against which those deductible temporary differences can be utilized. Such deferred tax assets and liabilities are not recognized if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

The carrying amount of deferred tax assets is reviewed at the end of the reporting period and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the liability is settled or the asset is realized, based on tax rate (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities. Current and deferred tax is recognized in profit or loss, except when it relates to items that are recognized in other comprehensive income, in which case the current and deferred tax are also recognized in other comprehensive income.

For the purposes of measuring deferred tax liabilities or deferred tax assets for investment properties that are measured using the fair value model, the carrying amounts of such properties are presumed to be recovered entirely through sale, unless the presumption is rebutted. The presumption is rebutted when the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.17 *Contingent liabilities and contingencies*

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Company. It can also be a present obligation arising from past events that is not recognized because it is not probable that an outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognized but is disclosed in the notes to the financial statements. When a change in the probability of an outflow occurs so that outflow is probable and the amount can be reliably measured, it will then be recognized as a provision.

2.3.18 *Fiduciary activities*

In activities where the Company acts in a fiduciary capacity such as trustee, custodian or agent, the assets and income arising from the transaction together with the related undertakings to return the assets to customers are excluded from the Company's financial statements.

2.3.19 *Acceptances*

Acceptances comprise the Company's commitments on payment for bills that are issued to customers. Acceptances are accounted for as financial guarantees and credit related commitments and are disclosed as contingent liabilities and commitments.

2.3.20 *Employee benefits*

(i) Employee leave entitlements

Liabilities for wages and salaries, including non-monetary benefits and accumulating sick leave that are expected to be settled wholly within 12 months after the end of the period in which the employees render the related service are recognized in respect of employees' services up to the end of the reporting period and are measured at the amounts expected to be paid when the liabilities are settled.

(ii) Retirement benefit schemes

The Company contributes to defined contribution schemes under either recognized Occupational Retirement Schemes Ordinance (ORSO) Schemes or Mandatory Provident Fund (MPF) Schemes that are available to the Company's employees. Contributions to the schemes by the Company and employees are calculated as a percentage of employees' basic salaries for the ORSO schemes and in accordance with the MPF rules for MPF schemes. When an employee leaves the Company prior to his/her interest in the Company's employer non-mandatory contributions vesting with the employee, the ongoing contributions payable by the Company may be reduced by the relevant amount of forfeited contributions.

The assets of the schemes are held in independently-administered funds separate from those of the Company.

2.3.21 *Offset financial assets and liabilities*

Financial assets and liabilities are offset and the net amount is reported in the statement of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis or realize the assets and settle the liability simultaneously.

Notes to the Financial Statements

For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 Significant Accounting Policies *(continued)*

2.3.22 Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The chief operating decision maker is the person or Company that allocates resources to and assesses the performance of the operating segments of an entity. The Company has determined the senior management team represented by the governor as its chief operating decision maker.

An operating segment is a component of the Company with all of the following conditions are satisfied: (1) that component can earn revenues and incur expenses from ordinary activities; (2) the component's operating results are regularly reviewed by the chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and (3) discrete financial information for the component is available to the Company. If two or more operating segments have similar economic characteristics, and certain conditions are satisfied, they may be aggregated into a single operating segment.

Intra-segment income and expenses are eliminated. Income and expenses directly associated with each segment are considered in determining segment performance.

2.3.23 Foreign currency translation

HK\$ is the currency of the primary economic environment in which the Company operates. Therefore, the Company chooses HK\$ as their functional currency and adopts HK\$ to prepare its financial statements.

In preparing the financial statements, transactions in currencies other than the functional currency of that entity (foreign currencies) are recorded in the respective functional currency (i.e. the currency of the primary economic environment in which the entity operates) at the rates of exchanges prevailing on the dates of the transactions.

At the reporting date, foreign currency monetary items are translated into HK\$ using the spot exchange rates at the reporting date. Exchange differences arising from the differences between the spot exchange rates prevailing at the reporting date and those on initial recognition or at the previous reporting date are recognized in profit or loss for the period except that (1) exchange differences related to hedging instruments for the purpose of hedging against foreign exchange risks are accounted for using hedge accounting and (2) exchange differences arising from available-for-sale non-monetary items denominated in foreign currencies and changes in the carrying amounts (other than the amortized cost) of available-for-sale monetary items are recognized as other comprehensive income.

2.4 Critical accounting estimates and judgements in applying accounting policies

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expense.

In preparing these financial statements, the significant judgements made by management in applying the Company's accounting policies and the key sources of estimation uncertainty were as follow:

Notes to the Financial Statements

For the year ended 31 December 2018
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

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

(a) Measurement of the expected credit loss ("ECL") allowance

The measurement of the expected credit loss allowance for financial assets measured at amortized cost and fair value through other comprehensive income is an area that requires the use of complex models and significant assumptions about future economic conditions and credit behavior (e.g. the likelihood of customers defaulting and the resulting losses). Explanation of the inputs, assumptions and estimation techniques used in measuring ECL is further detailed in note 3.1.2 and 3.1.3, which also sets out key sensitivities of the ECL to changes in these elements.

A number of significant judgements are also required in applying the accounting requirements for measuring ECL, such as:

- Determining criteria for significant increase in credit risk;
- Choosing appropriate models and assumptions for the measurement of ECL;
- Establishing the number and relative weightings of forward-looking scenarios for each type of product/market and the associated ECL; and
- Establishing group of similar financial assets for the purposes of measuring ECL.

Detailed information about the judgements and estimates made by the Company in the above areas is set out in note 3.1.2.

(b) Fair value of financial instruments

The fair values of financial instruments that are not quoted in active markets are determined by using valuation techniques (e.g. discounted cash flow model). To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty's), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

3 FINANCIAL RISK MANAGEMENT

The Company's activities expose it to a variety of financial risks and those activities involve analysis, evaluation, acceptance and management of a certain degree of risks or a portfolio of risks. The Company's aim is to achieve an appropriate balance between risk and return and minimize potential adverse effects on the Company's financial performance.

The Company's risk management policies are designed to identify and analyze these risks, to set appropriate risk limits and controls, and to monitor the risks and adherence to limits by means of reliable and up-to-date information systems. The Company regularly reviews its risk management policies and systems to reflect changes in markets, products and the latest best practice.

The Board of Directors sets out strategies and risk preference for overall risk management strategy and decides the risk tolerance level. The senior management establishes related risk management policies and procedures under the strategy approved by the Board of Directors. Business Units act as the first line of defense in risk management while the Risk Management Department undertakes the main risk management operational functions of the Company. In addition, internal audit department is responsible for the independent review of risk management and the control environment.

The main types of financial risks of the Company are credit risk, liquidity risk, market risk and operational risk, etc. Market risk also includes foreign exchange risk, interest rate risk and other price risk.

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk

Credit risk, the risk that a borrower or counterparty of the Company will be unable or unwilling to honor a repayment obligation, is one of the key risks encountered by the Company as the Company's main business is still dominated by credit business such as lending, billing and stock financing. If credit deterioration or default occurs, it will cause certain losses and affect the Company's business stability. Therefore, the risks must be strictly monitored. Starting with quality of business, the monitoring approach includes not only rigorous credit review but also ongoing post-lending monitoring. This ensures that the non-performing loan ratio is less than risk tolerance and there is sufficient provision for coverage. The Company manages and controls the overall credit risk in a prudent manner and reports regularly to the senior management and the Board of Directors of the Company.

3.1.1 Credit risk management

The Company's credit risk management is assumed by major functions including Corporate Business Management Department, Retail Business Management Department, Credit Card Centre, Credit Management Department, Risk Management Department, and Finance Department, which are responsible for the standardized management for corporate and retail credit businesses in terms of credit investment, credit investigation and report, credit approval, loan granting, post-loan monitoring and non-performing loan management.

(a) Loans and advances to customers

As for corporate loans, the Company's relationship managers are responsible for receiving application files submitted by the applicants, conducting pre-loan investigation, assessing the credit risk suffered by applicants and relevant businesses, and completing initial internal rating. The Company adopts the hierarchical approval system based on the credit approval authority. Credit line is determined by taking into account the credit record, financial position, collaterals and guarantees of the applicant, overall credit risk of the credit portfolio, macroeconomic regulation and control policies and relevant laws and regulations. The Company keeps a close eye on the economic and financial trend and credit risk profile in the industry and provides more guidance on credit investment by formulating guidance for different industries. It strengthens daily risk pre-warning, monitoring and specific risk investigation to identify customers under major risks and material potential risk points. With improvements in post-loan management, the Company enhanced the refinement of post-loan management in a practical manner. The independent Credit Management Department shall review the compliance, completeness and effectiveness of relevant credit files before loan granting according to the applications for drawdown of credit line. The Company's relationship manager is the person primarily responsible for post-loan management. The Company adopts a series of tools and approaches, such as risk filtering, list management, risk warning and risk investigation, in daily risk monitoring of corporate loans. To minimize the losses arising from credit risks, the Company manages NPLs mainly through (1) collection; (2) restructuring; (3) disposal of collaterals or recourse to the guarantor; (4) litigation or arbitration; and (5) write-off pursuant to regulations and requirements.

For retail credit assets, the Company adopts categorized management for retail credit assets on the basis of overdue ageing and guarantee mode. With regard to retail credit customers with overdue loans, different approaches are adopted to collect such loans based on their overdue days. Retail credit businesses overdue by a certain period shall be managed as impaired assets and relevant impairment allowance shall be provided for such assets.

Credit Card Centre accounted for independently by the Company is in charge of the operation and management of credit card business. Credit Card Centre of the Company adopts various supervisory and preventive measures simultaneously. It reinforces data cross-validation to enhance risk prevention in the approval process, tightens credit line on high risk customers through secondary credit investigation to enter into the collection process earlier than scheduled, deploys collection strength in a proper manner to significantly enhance collection efficiency, and optimizes data analytic system to further propel the refined management of credit card business.

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.1 Credit risk management *(continued)*

(b) Treasury business

For treasury business, the Company chooses banks and other financial institutions prudently and balances the credit risk and return rate of investments. By making reference to internal and external credit rating information, the Company adopts hierarchical credit and uses an appropriate credit limit management system to review and adjust credit lines, aiming to manage the credit risk exposed to the treasury business.

For debt investments, internal and external ratings (such as Standard and Poor's) are used by the Company when available for managing the credit risk exposed to debt investments and bills. The investment in those debts and bills is to have better credit quality assets while maintaining readily available funding sources. The bond issuers involved with the Company are subject to the credit granting review and approval of the Global Market Department and credit limits are placed on such issuers.

As for derivative instruments, the Company maintains strict limits on net open derivative investment positions (i.e., the difference between long and short contracts), by both amount and maturity. At any time, the amount subject to credit risk is limited to the current fair value of instruments that are favourable to the Company (i.e., assets where their fair value is positive), which, in relation to derivative instruments, is only a fraction of the contract's notional amount used to express the amount outstanding. This credit risk exposure is managed as part of the overall lending limits with customers, together with potential exposures from market fluctuations. Collateral or other security is not usually obtained for credit risk exposures on these instruments, except when the Company requires margin deposits from counterparties. The management has set limits of these contracts according to counterparty, and regularly monitor and control the actual credit risk when the Company concludes foreign exchange and interest rate contracts with other financial institutions and clients.

The Company manages the credit quality of due from and placements with banks and other financial institutions by considering the size, financial position and the external credit rating of the banks and financial institutions. The Risk Management Department monitors and reviews the credit risk of due from and placements with banks and other financial institutions by counterparties periodically. Limits are placed on different counterparties.

(c) Credit-related commitments

Credit risk exposures to financial guarantees are the same as that of loans. However, commercial letters of credit are usually pledged by the relevant shipped goods, and therefore is subject to lower risk compared with direct loans. Credit related commitments are included in the management of overall credit line granted to the applicant. For customers with transactions beyond the credit limit or infrequent transactions, the applicant shall be requested to provide relevant guarantee in order to reduce credit risk exposures.

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.1 Credit risk management *(continued)*

(d) Credit risk quality

In accordance with the Guideline on Loan Classification System issued by the Hong Kong Monetary Authority (“HKMA”), the Company has established a loan credit risk classification system and performs credit risk management based on loan classification in one of five categories. The Company classifies loans into the following five categories: normal, special-mention, substandard, doubtful and loss, of which substandard, doubtful and loss loans are regarded as non-performing loans.

The five categories of loan classification into which the Company classifies its loans and advances to customers are set out below:

Pass:	Loans for which borrowers are current in meeting commitments and for which the full repayment of interest and principal is not in doubt.
Special-mention:	Loans with which borrowers are experiencing difficulties and which may threaten the authorized institution’s position.
Substandard:	Loans in which borrowers are displaying a definable weakness that is likely to jeopardise repayment.
Doubtful:	Loans for which collection in full is improbable and the authorized institution expects to sustain a loss of principal and/or interest, taking into account the net realizable value of collateral.
Loss:	Loans that are considered uncollectable after all collection options (such as the realization of collateral or the institution of legal proceedings) have been exhausted.

Regarding risk, the treasury business is classified into five categories based on five categories of loan classification.

(e) Credit risk measurement

The Company has established an internal rating system to measure credit risk arising from default events.

The credit risk internal rating system considers the “probability of default” by debtors (or debts). This is similar to the approach used for the purposes of measuring Expected Credit Loss (“ECL”) under HKFRS 9. Please refer to note 3.1.2 for more details.

Probability of default is the probability of occurrence of default event in a given period of time in future.

Exposure at default represents the total amount of on-balance sheet and off-balance sheet exposure at the time of default by debtor, reflecting the total amount of possible losses to be incurred. In general, this includes the utilized credit limit, interest receivable, the anticipated usage of unused credit facilities as well as the related expenses to be incurred.

Loss given default represents the percentage of amount of loss to be occurred in the event of default to the total risk exposure. It is expressed as the loss percentage per unit of exposure which typically varies by nature of debtor, type and seniority of claim and the availability of collaterals or other credit enhancements.

The Company summarized a series of financial and other related factors to build the internal credit rating model to measure the probability of default, which is based on historical data collection, data statistics and data analysis on the characteristics of risks of the clients/debts before the default occurs. Internal rating model applies the principle of regression to forecast the probability of default and then matches the probability of default with relevant rank of default risk which is used for determination of the borrower’s credit ranking within the internal rating system. In order to improve the model’s accuracy and stability, the Company performs evaluation of the model every three months and monitors the results by performing back testing and comparing the results from model using the default from customers.

The above credit risk factors are considered for the measurement of possible credit losses to be incurred, and applied in the daily operations of the Company.

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.1 Credit risk management *(continued)*

(e) Credit risk measurement (continued)

For retail business, the assets are categorized and credit risk is measured by aging analysis.

For corporate business, the rating is determined at the borrower level. A relationship manager will incorporate any updated or new information/credit assessments into the credit system on an ongoing basis. In addition, the relationship manager will also update information about the creditworthiness of the borrower every year from sources such as public financial statements. This will determine the updated internal credit rating and the probability of default.

For debt securities in the Treasury portfolio, external rating agency credit grades are mapped onto the master scale. These published grades are continuously monitored and updated. The mapping to the master scale will determine the updated internal credit rating and the probability of default.

The Company's rating method comprises 18 rating levels for instruments not in default (1.1 to 1.4, 2 to 15) and one default class. The master scale assigns each rating category a specific range of probabilities of default, which is stable over time. The rating methods are subject to annual validation and recalibration so that they reflect the latest projections in light of all actual observed defaults.

The Company's internal rating scale and mapping of external ratings are set out below:

Internal Rating	PD Range	Corresponding Rating (S&P)	Description of Grade
1.1 – 4	0.03% – 0.53%	AAA to BBB–	Investment Grade
5 – 11	0.53% – 14.07%	BB+ to B–	Standard Monitoring
12 – 15	14.07% – 99.99%	CCC+ to C	Special Monitoring
Default	100.00%	D	Default

3.1.2 Expected credit loss measurement

HKFRS 9 outlines a 'three-stage' model for impairment based on changes in credit quality since initial recognition as summarized below:

- If the credit risk on a financial instrument has not increased significantly since initial recognition, the financial instrument is classified in 'Stage 1' and has its credit risk continuously monitored by the Company.
- If a significant increase in credit risk ('SICR') since initial recognition is identified, the financial instrument is moved to 'Stage 2' but is not yet deemed to be credit-impaired. Please refer to note 3.1.2.1 for a description of how the Company determines when a significant increase in credit risk has occurred.
- If the financial instrument is credit-impaired, the financial instrument is then moved to 'Stage 3'. Please refer to note 3.1.2.2 for a description of how the Company defined credit-impaired and default.
- Financial instruments in Stage 1 have their ECL measured at an amount equal to the portion of lifetime expected credit losses that result from default events possible within the next 12 months. Instruments in Stages 2 or 3 have their ECL measured based on expected credit losses on a lifetime basis. Please refer to note 3.1.2.3 for a description of inputs, assumptions and estimation techniques used in measuring the ECL.
- A pervasive concept in measuring ECL in accordance with HKFRS 9 is that it should consider forward-looking information. Note 3.1.2.4 includes an explanation of how the Company has incorporated this in its ECL models.
- Purchased or originated credit-impaired financial assets are those financial assets that are credit-impaired on initial recognition. Their ECL is always measured on a lifetime basis.

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.2 Expected credit loss measurement *(continued)*

The following diagram summarizes the impairment requirements under HKFRS 9 (other than purchased or originated credit-impaired financial assets):

Stage 1	Stage 2	Stage 3
(Initial recognition)	(Significant increase in credit risk since initial recognition)	(Credit-impaired assets)
12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses

The key judgements and assumptions adopted at the Company in addressing the requirements of the standards are addressed below.

3.1.2.1 Significant increase in credit risk (SICR)

The criteria for the determination of “a significant increase in credit risk” includes but is not limited to the following factors:

(a) Notch difference

For investment securities, significant increase in credit risk is assessed based on the notch difference threshold by comparing ratings at measurement date and initial recognition date.

Internal Rating	Notch Difference
1.1 – 1.3	4
1.4 – 4	3
5 – 8	2
9 – 15	1

(b) Day past due

Different levels of day past due are considered as significant credit deterioration criteria for different portfolios.

(c) Watch list

Qualitative and forward-looking information, e.g. industry outlook of obligor, future organization, restructure plan of obligor, are considered as criteria of adding to the watch list, which is considered as significant increase in credit risk. For investment securities, significant decrease in market price and external rating are considered as significant increase in credit risk.

(d) HKMA ratings

Under HKMA’s Guideline on Loan Classification System, the Special Mention grade is considered as threshold for retail loan, corporate loan and credit card portfolio.

(e) Other risk alarm indicators imply growing potential risk, and could cause losses of financial assets to the Company.

The financial assets are moveable between stages. For instance, financial instruments originally classified at stage 1 should be downgraded to stage 2 if events occur such as a significant increase in credit risk. Financial instruments at stage 2 could be upgraded to stage 1 if credit risk decreases and the criteria for the determination of “a significant increase in credit risk” are no longer met.

The assessment of significant increase in credit risk incorporates forward-looking information (refer to note 3.1.2.4 for further information) and is performed on a periodic basis at a counterparty level for all financial instruments held by the Company.

Notes to the Financial Statements

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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.2 Expected credit loss measurement *(continued)*

3.1.2.2 Definition of default and credit-impaired assets

The Company defines a financial instrument as in default, which is fully aligned with the definition of credit-impaired, when it meets one or more of the following criteria:

- The borrower is more than 90 days past due on its contractual payments (with the sole exception of credit card where a borrower only needs to be 60 days past due to be considered in default).
- The borrower has been classified as Substandard, Doubtful or Loss under the HKMA classification system.
- The loan has been placed on individual assessment list (applicable only to loans).

The credit impairment definition has been applied consistently to model the probability of default, exposure at default and loss given default throughout the Company's expected loss calculations.

3.1.2.3 Measuring ECL – Explanation of inputs, assumptions and estimation techniques

The ECL is measured on either a 12-month or lifetime basis depending on whether a significant increase in credit risk has occurred since initial recognition or whether an asset is considered to be credit-impaired. Expected credit losses are the discounted product of the Probability of Default (PD), Exposure at Default (EAD), and Loss Given Default (LGD), defined as follows:

- The PD represents the likelihood of a borrower defaulting on its financial obligation (as per "Definition of credit-impaired" above), either over the next 12 months (12M PD), or over the remaining lifetime (Lifetime PD) of the obligation.
- EAD is based on the amounts the Company expects to be owed at the time of default. For example, for a revolving commitment, the Company includes the current drawn balance plus any further amount that is expected to be drawn up to the current contractual limit by the time of default, should it occur.
- LGD represents the Company's expectation of the extent of loss on a defaulted exposure. LGD varies by type of counterparty, type and seniority of claim and availability of collateral or other credit support. LGD is expressed as a percentage loss per unit of exposure at the time of default (EAD).

The ECL is determined by projecting the PD, LGD and EAD for each future year and for each individual exposure. These three components are multiplied together and adjusted for the likelihood of survival (i.e. the exposure has not prepaid or defaulted in an earlier year). This effectively calculates an ECL for each future year, which is then discounted back to the reporting date and summed. The discount rate used in the ECL calculation is the original effective interest rate or an approximation thereof.

The Lifetime PD is developed by using forecasted macroeconomic factor to calculate a forecasted 12M PD for the 2nd to 5th year. For the years after the fifth year, it is assumed that the PD will remain the same.

EAD represents the total amount of on-balance sheet and off-balance sheet exposure at the time of default by debtor, reflecting the total amount of possible losses to be incurred. In general, this includes the utilized credit limit, interest receivable, the anticipated usage of unused credit facilities as well as the related expenses to be incurred.

LGDs are determined based on the factors which impact the recoveries made post default. These vary by product type.

- For secured products, this is primarily based on collateral type and projected collateral values, historical discounts to market/book values due to forced sales, time to repossession and recovery costs observed.
- For unsecured products, LGD's are typically set at product level due to the limited differentiation in recoveries achieved across different borrowers. These LGD's are influenced by collection strategies, including contracted debt sales and price.

Notes to the Financial Statements

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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.2 Expected credit loss measurement *(continued)*

3.1.2.4 Forward-looking information incorporated in the ECL models

The assessment of SICR and the calculation of ECL both incorporate forward-looking information. The Company has performed historical analysis and identified the key economic variables impacting credit risk and expected credit losses for each portfolio.

These economic variables and their associated impact on the PD, EAD and LGD vary by financial instrument. Expert judgment has also been applied in this process. Forecasts of these economic variables (the “base economic scenario”) over the next five years are gathered from economics team of the Bank of Communications Co. Ltd., HKBR’s Development Strategy Team and the International Monetary Fund (IMF). After five years, economic variables are assumed to remain stable and the last available forecast is used. The impact of these economic variables on the PD, EAD and LGD has been determined by performing statistical regression analysis to understand the impact changes in these variables have had historically on default rates and on the components of LGD and EAD.

In addition to the base economic scenario, the Company’s Risk Management Department and Development Strategy Team have also considered other economic scenarios which are calculated using historical data, along with weightings for each of the scenarios. The number of other scenarios used is set based on the analysis of each major product type to ensure non-linearities are captured. The number of scenarios and their attributes are reassessed at each reporting date. At 1 January 2018 and 31 December 2018, the Company concluded that three scenarios appropriately captured non-linearities. The scenario weightings are determined by a combination of statistical analysis and expert credit judgement, taking account of the range of possible outcomes each chosen scenario is representative of.

Following this assessment, The Company then measures ECL as either a probability weighted 12 month ECL (Stage 1), or a probability weighted lifetime ECL (Stages 2 and 3). These probability-weighted ECLs are determined by running each scenario through the relevant ECL model and multiplying it by the appropriate scenario weighting (as opposed to weighting the inputs).

As with any economic forecasts, the projections and likelihoods of occurrence are subject to a high degree of inherent uncertainty and therefore the actual outcomes may be significantly different to those projected. The Company considers these forecasts to represent its best estimate of the possible outcomes and has analyzed the non-linearities and asymmetries within the Company’s different portfolios to establish that the chosen scenarios are appropriately representative of the range of possible scenarios. The proposed macroeconomic forecasts and probability weightings are subject to management review.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.2 Expected credit loss measurement *(continued)*

3.1.2.4 Forward-looking information incorporated in the ECL models *(continued)*

Economic variable assumptions

The scenarios "base", "upside" and "downside" were used for all portfolios. The most significant period-end assumptions used for the ECL estimate as at 31 December 2018 are set out below.

		2019	2020	2021	2022	2023
Hong Kong CPI	Base	1.50%	1.50%	1.50%	1.50%	1.50%
	Upside	6.32%	5.84%	2.86%	-4.02%	-3.69%
	Downside	-1.66%	-3.06%	-2.50%	-0.45%	0.90%
Hong Kong Unemployment rate	Base	3.20%	3.30%	3.40%	3.50%	3.50%
	Upside	2.77%	2.20%	4.70%	6.25%	4.95%
	Downside	5.09%	7.32%	7.94%	6.81%	5.59%
China Real GDP (first difference)	Base	-0.20%	0.00%	-0.10%	-0.10%	-0.10%
	Upside	-1.08%	-0.65%	-1.58%	-0.03%	0.75%
	Downside	-0.10%	0.67%	0.98%	0.13%	1.15%
US Real GDP (first difference)	Base	-0.34%	-0.73%	-0.09%	-0.24%	-0.11%
	Upside	1.08%	0.69%	-0.04%	0.24%	-0.59%
	Downside	-3.12%	0.81%	1.02%	0.98%	-0.44%

The weightings assigned to each economic scenario as at 31 December 2018 were as follows:

Upside	Base	Downside
25%	60%	15%

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.2 Expected credit loss measurement *(continued)*

3.1.2.4 Forward-looking information incorporated in the ECL models *(continued)*

Economic variable assumptions (continued)

The most significant period-end assumptions used for the ECL estimate as at 1 January 2018 are set out below.

		2018	2019	2020	2021	2022
Hong Kong CPI	Base	1.50%	1.50%	1.50%	1.50%	1.50%
	Upside	6.32%	5.84%	2.86%	-4.02%	-3.69%
	Downside	-1.66%	-3.06%	-2.50%	-0.45%	0.90%
Hong Kong Unemployment rate	Base	3.00%	3.10%	3.10%	3.10%	3.10%
	Upside	2.77%	2.20%	4.70%	6.25%	4.95%
	Downside	5.09%	7.32%	7.94%	6.81%	5.59%
China Real GDP (first difference)	Base	-0.10%	-0.10%	0.00%	-0.20%	-0.20%
	Upside	-1.08%	-0.65%	-1.58%	-0.03%	0.75%
	Downside	-0.10%	0.67%	0.98%	0.13%	1.15%
US Real GDP (first difference)	Base	-0.17%	-0.43%	-0.14%	-0.06%	-0.06%
	Upside	1.08%	0.69%	-0.04%	0.24%	-0.59%
	Downside	-3.12%	0.81%	1.02%	0.98%	-0.44%

The weightings assigned to each economic scenario as at 1 January 2018 were as follows:

Upside	Base	Downside
35%	50%	15%

Other forward-looking considerations not otherwise incorporated within the above scenarios, such as the impact of any regulatory, legislative or political changes, have also been considered, but are not deemed to have a material impact and therefore no adjustment has been made to the ECL for such factors. This is reviewed and monitored for appropriateness on a quarterly basis.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.2 Expected credit loss measurement *(continued)*

3.1.2.4 Forward-looking information incorporated in the ECL models *(continued)*

Sensitivity analysis

The following table presents the base ECL scenario compared to the probability-weighted ECL derived from using three ECL scenarios. The difference reflects the impact of deriving multiple scenarios around the base ECL and resultant change in ECL due to non-linearity and sensitivity to using macroeconomic forecasts.

	As at 31 December 2018
Change from Base to Probability-weighted ECL	
Probability-weighted ECL	324,147
Base ECL	291,262
Difference in amount	32,885
Difference in percentage	10.1%

3.1.3 Credit risk exposure

3.1.3.1 Maximum exposure to credit risk – Financial instruments subject to impairment

The following tables contain an analysis of the credit risk exposure of financial instruments for when an ECL allowance is recognized.

The gross carrying amount of financial assets below also represents the company's maximum exposure of credit risk on these assets.

	2018				2017 (restated) Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total	
Corporate Loan					
Investment Grade	12,460,563	–	–	12,460,563	36,065,231
Standard Monitoring	9,131,492	10,358	–	9,141,850	112,873,573
Special Monitoring	–	50,606	–	50,606	28,595
Defaults	–	–	17,900	17,900	495,881
Unrated	17,943,052	18,597	–	17,961,649	79,537,329
Gross carrying amount	39,535,107	79,561	17,900	39,632,568	229,000,609
Loss allowance	(141,821)	(8,578)	(8,236)	(158,635)	(1,170,762)
Carrying amount	39,393,286	70,983	9,664	39,473,933	227,829,847

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT (continued)

3.1 Credit risk (continued)

3.1.3 Credit risk exposure (continued)

3.1.3.1 Maximum exposure to credit risk – Financial instruments subject to impairment (continued)

	2018				2017 (restated) Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total	
Retail loan					
Investment Grade	27,871,785	6,467	–	27,878,252	28,517,567
Standard Monitoring	168,877	165,443	182	334,502	227,272
Special Monitoring	–	29,377	208	29,585	1,719
Defaults	–	–	46,026	46,026	18,377
Gross carrying amount	28,040,662	201,287	46,416	28,288,365	28,764,935
Loss allowance	(34,877)	(23,384)	(15,318)	(73,579)	(226,274)
Carrying amount	28,005,785	177,903	31,098	28,214,786	28,538,661
	2018				2017 (restated) Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total	
Due from banks and other financial institutions					
Investment Grade	25,088,522	–	–	25,088,522	105,855,209
Gross carrying amount	25,088,522	–	–	25,088,522	105,855,209
Loss allowance	(6,085)	–	–	(6,085)	–
Carrying amount	25,082,437	–	–	25,082,437	105,855,209
	2018				2017 (restated) Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total	
Investment Securities					
Investment Grade	109,305,072	–	–	109,305,072	186,313,547
Gross carrying amount	109,305,072	–	–	109,305,072	186,313,547
Loss allowance	(61,089)	–	–	(61,089)	–

Information on how the Expected Credit Loss (ECL) is measured and how the three stages above are determined is included in notes 3.1.2.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.3 Credit risk exposure *(continued)*

3.1.3.2 Maximum exposure to credit risk – Financial instruments not subject to impairment

The following table contains an analysis of the maximum credit risk exposure from financial assets not subject to impairment:

	Maximum exposure to credit risk	
	2018	2017 (restated)
Financial assets at fair value through profit or loss		
Derivative financial instruments	1,290,050	9,081,422
Government bonds	544,483	6,142,431
Other debt securities	20,821	5,066,460
Total	1,855,354	20,290,313

3.1.3.3 Collateral and other credit enhancements

The Company manages limits and controls concentrations of credit risk wherever they are identified, in particular, to individual counterparties, company and groups and geographical regions.

The Company structures the levels of credit risk it undertakes by placing limits in relation to one borrower, or group of borrowers. Such risks are monitored on a regular basis and subject to annual or more frequent review, whenever necessary.

The exposure to any single borrower including banks and brokers is further restricted by sub-limits covering on-balance and off-balance sheet exposures, and daily delivery risk limits in relation to trading items such as forward foreign exchange contracts. Actual exposures against limits are monitored daily.

Exposure to credit risk is also managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and principal repayment obligations and by changing their lending limits where appropriate.

Some other specific control and risk mitigation measures are outlined below:

(a) Collaterals

The Company employs a range of policies and practices to mitigate credit risk. The most useful practice is to accept collaterals. The Company implements guidelines on the acceptability of specific classes of collaterals. The principal types of collaterals for loans and advances to customers are:

- Residential properties;
- Business assets such as premises, inventory and accounts receivable;
- Financial instruments such as debt securities and stocks.

Long-term loans and advances to corporate and individual customers are generally secured; while revolving individual credit facilities are generally unsecured. In addition, in order to minimize the credit loss the Company will seek additional collaterals from the counterparties as soon as impairment indicators are noted for the relevant individual loans and advances.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.3 Credit risk exposure *(continued)*

3.1.3.3 Collateral and other credit enhancements *(continued)*

*(a) Collaterals *(continued)**

For loans guaranteed by a third-party guarantor, the Company will assess the financial condition, credit history and ability to meet obligations of the guarantor.

Collaterals held as security for financial assets other than loans and advances to customers are determined by the nature of the instrument. Debt securities and treasury bonds are generally unsecured, with the exception of asset backed securities, which are secured by portfolios of financial instruments.

The Company closely monitors collateral held for financial assets considered to be credit-impaired, as it becomes more likely that the Company will take possession of collateral to mitigate potential credit losses. Financial assets that are credit-impaired and related collateral held in order to mitigate potential losses are shown below:

As at 31 December 2018:

	Gross exposure	ECL allowance	Carrying amount	Fair value of collateral held
Loans to individuals	46,416	(15,318)	31,098	29,241
Loans to corporate entities	17,900	(8,236)	9,664	9,664
	64,316	(23,554)	40,762	38,905

As at 31 December 2017 (restated):

	Gross exposure	Impairment allowance	Carrying amount	Fair value of collateral held
Loans to individuals	22,149	(15,012)	7,137	5,385
Loans to corporate entities	534,753	(272,175)	262,578	398,639
	556,902	(287,187)	269,715	404,024

(b) Master netting arrangements

The Company further restricts its exposure to credit losses by entering into master netting arrangements with counterparties with which it undertakes a significant volume of transactions. Master netting arrangements do not generally result in an offset of assets and liabilities in the statement of financial position, as transactions are usually settled on a gross basis. However, the credit risk associated with favourable contracts is reduced by a master netting arrangement to the extent that if a default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Company's overall exposure to credit risk on derivative instruments subject to master netting arrangements can change substantially within a short period, as each transaction subject to the arrangement affects credit risk.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Loss allowance

The loss allowance recognized in the period is impacted by a variety of factors, such as:

- Transfers between Stage 1 and Stages 2 or 3 due to financial instruments experiencing significant increases (or decreases) of credit risk or becoming credit-impaired in the period, and the consequent step up (or step down) between 12-month and Lifetime ECL;
- Additional allowances for new financial instruments recognized during the period, as well as releases for financial instruments derecognized in the period;
- Impact on the measurement of ECL due to changes in PDs, EADs and LGDs in the period, arising from regular refreshing of inputs to models;
- Discount unwind within ECL due to the passage of time, as ECL is measured on a present value basis;
- Financial assets derecognized during the period and write-offs of allowances related to assets that were written off during the period (see note 3.1.5).

The following tables explain the changes in the loss allowance between the beginning and the end of the annual period due to these factors:

	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Corporate loan				
Loss allowance as at 1 January 2018	875,665	34,744	264,855	1,175,264
Transfer of Excluded Business to HKBR (Note 2)	(856,478)	(34,654)	(242,222)	(1,133,354)
Transfers:				
Transfer from Stage 1 to Stage 2	(738)	738	–	–
Transfer from Stage 1 to Stage 3	(10)	–	10	–
Transfer from Stage 2 to Stage 1	–	–	–	–
Transfer from Stage 2 to Stage 3	–	–	–	–
Transfer from Stage 3 to Stage 1	–	–	–	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	173,404	(12)	(17,896)	155,496
Changes in PDs/LGDs/EADs	(26,084)	7,735	272	(18,077)
Foreign Exchange and other movements	(23,938)	27	3,217	(20,694)
Loss allowance amount as at 31 December 2018	141,821	8,578	8,236	158,635

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Loss allowance *(continued)*

Retail Loan	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Loss allowance amount as at 1 January 2018	45,526	28,937	22,332	96,795
Transfers:				
Transfer from Stage 1 to Stage 2	(347)	347	–	–
Transfer from Stage 1 to Stage 3	(47)	–	47	–
Transfer from Stage 2 to Stage 1	23,292	(23,292)	–	–
Transfer from Stage 2 to Stage 3	–	(84)	84	–
Transfer from Stage 3 to Stage 1	6	–	(6)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	(2,239)	(375)	57	(2,557)
Unwind of discount (Note a)	–	454	–	454
Changes in PDs/LGDs/EADs	(33,865)	17,395	6,064	(10,406)
Write-offs	–	–	(6,405)	(6,405)
Foreign Exchange and other movements	2,551	2	(6,855)	(4,302)
Loss allowance amount as at 31 December 2018	34,877	23,384	15,318	73,579

Note a: The unwind of discount on Stage 3 financial assets is reported within 'interest income' so that interest income is recognized on the amortized cost (after deducting the ECL allowance).

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Loss allowance *(continued)*

	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Loans and advances to customers				
Loss allowance amount as at 1 January 2018	921,191	63,681	287,187	1,272,059
Transfer of Excluded Business to HKBR (Note 2)	(856,478)	(34,654)	(242,222)	(1,133,354)
Transfers:				
Transfer from Stage 1 to Stage 2	(1,085)	1,085	–	–
Transfer from Stage 1 to Stage 3	(57)	–	57	–
Transfer from Stage 2 to Stage 1	23,292	(23,292)	–	–
Transfer from Stage 2 to Stage 3	–	(84)	84	–
Transfer from Stage 3 to Stage 1	6	–	(6)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	171,165	(387)	(17,839)	152,939
Changes in PDs/LGDs/EADs	(59,949)	25,130	6,336	(28,483)
Unwind of discount (Note a)	–	454	–	454
Write-offs	–	–	(6,405)	(6,405)
Foreign Exchange and other movements	(21,387)	29	(3,638)	(24,996)
Loss allowance amount as at 31 December 2018	176,698	31,962	23,554	232,214

Note a: The unwind of discount on Stage 3 financial assets is reported within 'interest income' so that interest income is recognized on the amortized cost (after deducting the ECL allowance).

	Year ended 31 December 2017		
	Collectively assessed (restated)	Individually assessed (restated)	Total (restated)
Balance at the beginning of the year	989,849	355,762	1,345,611
Net impairment allowances for loans charged to profit or loss	120,000	(1,086)	118,914
– <i>Impairment allowances for loans</i>	120,000	78,255	198,255
– <i>Reversal of impairment allowances for loans</i>	–	(79,341)	(79,341)
Recoveries of loans written-off in previous years	–	2,389	2,389
Write-offs	–	(69,878)	(69,878)
Balance at the end of the year	1,109,849	287,187	1,397,036

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Loss allowance *(continued)*

	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Due from banks and other financial institutions				
Loss allowance amount as at 1 January 2018	28,284	–	–	28,284
Transfer of Excluded Business to HKBR (Note 2)	(33,777)	–	–	(33,777)
New financial assets originated or purchased, assets derecognized, repayments and further lending	11,586	–	–	11,586
Foreign exchange and other movements	(8)	–	–	(8)
Loss allowance amount as at 31 December 2018	6,085	–	–	6,085
	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Investment Securities				
Loss allowance amount as at 1 January 2018	91,858	414	–	92,272
Transfer of Excluded Business to HKBR (Note 2)	(98,668)	(414)	–	(99,082)
New financial assets originated or purchased, assets derecognized, repayments and further lending	67,899	–	–	67,899
Loss allowance amount as at 31 December 2018	61,089	–	–	61,089
	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Financial guarantees and credit related commitment				
Loss allowance amount as at 1 January 2018	111,985	843	–	112,828
Loss allowance amount as at 31 December 2018	9,588	1,353	–	10,941

The following table further explains changes in the gross carrying amount to help explain their significance to the changes in the loss allowance for the same portfolio as discussed above:

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Loss allowance *(continued)*

Movement in gross carrying amount

	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Corporate loan				
Gross carrying amount as at 1 January 2018	225,391,235	3,074,621	534,753	229,000,609
Transfer of Excluded Business to HKBR (Note 2)	(200,702,708)	(2,566,843)	(448,179)	(203,717,730)
Transfers:				
Transfer from Stage 1 to Stage 2	(83,975)	83,975	–	–
Transfer from Stage 1 to Stage 3	(5,683)	–	5,683	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	14,936,160	(512,190)	(74,357)	14,349,613
Foreign Exchange and other movements	78	(2)	–	76
Gross carrying amount as at 31 December 2018	39,535,107	79,561	17,900	39,632,568
	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Retail loan				
Gross carrying amount as at 1 January 2018	28,553,939	188,847	22,149	28,764,935
Transfers:				
Transfer from Stage 1 to Stage 2	(171,510)	171,510	–	–
Transfer from Stage 1 to Stage 3	(28,322)	–	28,322	–
Transfer from Stage 2 to Stage 1	117,476	(117,476)	–	–
Transfer from Stage 2 to Stage 3	–	(263)	263	–
Transfer from Stage 3 to Stage 1	2	–	(2)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	(432,580)	(41,337)	2,090	(471,827)
Write-offs	–	–	(6,405)	(6,405)
Foreign Exchange and other movements	1,657	6	(1)	1,662
Gross carrying amount as at 31 December 2018	28,040,662	201,287	46,416	28,288,365

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For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Loss allowance *(continued)*

Movement in gross carrying amount (continued)

	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Due from banks and other financial institutions				
Gross carrying amount as at 1 January 2018	105,855,209	–	–	105,855,209
Transfer of Excluded Business to HKBR (Note 2)	(164,809,851)	–	–	(164,809,851)
New financial assets originated or purchased, assets derecognized, repayments and further lending	84,043,164	–	–	84,043,164
Gross carrying amount as at 31 December 2018	25,088,522	–	–	25,088,522
	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Investment securities				
Gross carrying amount as at 1 January 2018	185,586,498	727,049	–	186,313,547
Transfer of Excluded Business to HKBR (Note 2)	(245,146,574)	(727,049)	–	(245,873,623)
New financial assets originated or purchased, assets derecognized, repayments and further lending	168,865,148	–	–	168,865,148
Gross carrying amount as at 31 December 2018	109,305,072	–	–	109,305,072
	Stage 1 12-month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	Total
Financial guarantee and credit related commitment				
Gross carrying amount as at 1 January 2018	42,369,650	56,174	2,120	42,427,944
Gross carrying amount as at 31 December 2018	12,082,761	38,937	–	12,121,698

3.1.5 Write-off policy

The Company writes off financial assets, in whole or in part, when it has exhausted all practical recovery efforts and has concluded there is no reasonable expectation of recovery. Indicators that there is no reasonable expectation of recovery include but is not limited to (i) ceasing enforcement activity and (ii) where the Company's recovery method is foreclosing on collateral and the value of the collateral is such that there is no reasonable expectation of recovering in full.

The Company may write-off financial assets that are still subject to enforcement activity. The Company still seeks to recover amounts it is legally owed in full, but which have been partially written off due to no reasonable expectation of full recovery.

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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.6 Modification of Financial Assets

The amortized cost of financial assets that were modified during the year ended 31 December, 2018 was HK\$2.6 million before modification, with insignificant modification gain or loss. As of 31 December, 2018, there have been no significant modified assets for which the loss allowance has changed from lifetime to twelve month expected credit loss.

3.1.7 Derivative instruments

The Company undertakes its transactions in foreign exchange, interest rate derivative contracts and others with other financial institutions and customers. The management has established limits for these contracts based on counterparties, industry sectors and countries. Actual credit exposures and limits are regularly monitored and controlled by management.

Settlement risk arises mainly from foreign exchange transactions with counterparties and also from derivatives transactions in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty or customer to cover all settlement risk arising from the Company's market transactions on any single day.

3.1.8 Repossessed assets

Reposessed assets are collateral of the outstanding indebtedness that the Company takes possession of the collateral assets thorough court proceedings or voluntary delivery actions by the borrower. It will be sold as soon as practicable with the proceeds used to repay the outstanding indebtedness.

As at 31 December 2018, there was no reposessed asset (2017: HK\$ nil) that being held by the Company.

3.1.9 Concentration risk analysis for loans and advances to customers with credit risk exposure

The Company mainly manages concentration risk for loans and advances to customers by geographical sectors. The following tables are the geographical analysis of gross loans and advances to customers:

Geographical sectors

	2018	2017 (restated)
Mainland China	12,793,225	136,099,879
Hong Kong	54,913,438	112,763,201
Others	214,270	8,902,464
	67,920,933	257,765,544

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk

3.2.1 Overview

The Company takes on exposure to market risks, which is initiated by the fluctuation of the fair value of or future cash flow of financial instruments as a result of the changes of the market prices. Market risks arise from open positions in interest rates, exchange rates and equity products, all of which are exposed to market fluctuations and changes in interest rates, foreign exchange rates and equity products.

The Company established a management model of “large and small middle offices” for its market risk management, which is a centralized control framework led by Board of Directors and senior management. With the establishment of segregation of different duties, the Risk Management Department formulates market risk policies and ensures the Company’s exposure are within risk appetite of the Board of Directors, while Global Markets Department is the execution unit of market risk management. The Internal Audit Department is responsible for independent verification of the market risk management system policies and processes.

The Company monitors market risk separately in respect of trading portfolios and non-trading portfolios. The trading account consists of financial instruments held either for trading intent or economic hedging for other elements of the trading account. The banking account consists of the investments purchased by the Company with excess funds and other financial instruments that are not captured in the trading account.

With regard to the exchange rate risks and the interest rate risks of trading book, the Company established an effective limit management system by implementing Net Position, Risk Sensitivity, Value at Risk (“VaR”) and other indicators. Net interest income sensitivity analysis, interest rate repricing gap analysis and foreign exchange risk concentration analysis are the major tools used by the Company to monitor the market risk of its overall businesses. In addition, through adequate pricing management and asset allocation, the Company strived to maximize its rate of return while keeping its risks under control.

The Company has continuously improved the management system of market risk. The Company conducted stress tests on historical scenarios and hypothetical scenarios in the consideration of the Company’s major market risk factors. The Company has implemented daily automatic collection of trading data and market data in the system. The Company conducted the management of risk capital and VaR quota, and formulated the quota allocation plans.

As part of market risk management, the Company enters into interest rate swaps to match the interest rate risk associated with the structured deposits and fix-rate long-term debt securities.

The major measurement techniques used to measure and control market risk are outlined below:

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.2 VaR

VaR refers to the maximum loss that an investment portfolio may incur at a given confidence level and holding period caused by the changes in market price factors such as interest rates and exchange rates etc. The Company adopted the historical simulation method to calculate daily VaR (99% confidence interval, the holding period of one day).

A summary of VaR by risk type of the Company's portfolios is as follows:

Items	For the year ended 31 December 2018			
	31 December 2018	Average	Maximum	Minimum
VaR	1,187,944	2,437,630	24,085,016	387,398
– Interest rate risk	368,662	1,615,122	21,443,697	–
– Foreign exchange risk	1,312,398	3,326,807	35,901,718	387,398

Items	For the year ended 31 December 2017 (restated)			
	31 December 2017	Average	Maximum	Minimum
VaR	35,602,656	20,283,295	46,597,562	6,154,015
– Interest rate risk	20,993,857	20,069,313	34,724,440	11,472,209
– Foreign exchange risk	43,413,316	27,294,159	58,220,942	7,919,375

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.3 Sensitivity tests

Interest rate sensitivity test

The Company performs interest rate sensitivity analysis on net interest income for the Company by measuring the impact of a change in net interest income of financial assets and liabilities, not taking customer behaviour and repayment option into consideration.

On an assumption of a parallel shift of 100 basis points in RMB, USD and HKD interest rates, the Company calculates the changes in net interest income for the year on a monthly basis.

The table below illustrates the impact to net interest income of the coming year of the Company based on the structure of interest bearing assets and liabilities as at 31 December 2018 and 31 December 2017, caused by a parallel shift of 100 basis points of RMB, USD and HKD interest rates.

	Expected changes in net interest income	
	As at 31 December 2018	As at 31 December 2017 (restated)
+100 basis points parallel shift in yield curves	71,935	69,083
-100 basis points parallel shift in yield curves	(71,935)	(69,083)

The results of the interest rate sensitivity tests set out in the table above are illustrative only and are based on simplified scenarios. The figures represent the projected impact to the net interest income caused by the projected movement of current interest risk structure yield curves. This effect, however, does not take into account actions that would be taken by the Company to mitigate the impact of interest rate changes. The projections above also assume that interest rates of all maturities excluding demand deposits move by the same amount and, therefore, do not reflect the potential impact on net interest income due to changes in certain rates while others remain unchanged. The projections make other simplifying assumptions as well, including that all positions are to be held to maturity. There will be changes to the projection if positions are not held to maturity but it is not expected that the changes would be material.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.3 Sensitivity tests *(continued)*

Foreign exchange sensitivity test

The Company performs exchange rate sensitivity analysis on net profit and other comprehensive income for the Company by measuring the impact of a change in exchange rate on financial assets and liabilities denominated in different currencies. Since HK\$ is pegged to USD under linked exchange rate system, no sensitivity analysis against USD is presented. On an assumption of an appreciation or depreciation of HK\$ spot and forward rates against RMB by 5%, the Company calculates the changes in net profit and other comprehensive income for the year on a monthly basis.

The table below illustrates the impact of an appreciation or depreciation of HK\$ spot and forward rates against RMB by 5% on the Company's net profit:

	Expected changes in net profit	
	As at 31 December 2018	As at 31 December 2017 (restated)
5% appreciation of HK\$	1,457,002	1,331,820
5% depreciation of HK\$	(1,457,002)	(1,331,820)

The table below illustrates the impact of an appreciation or depreciation of HK\$ spot and forward rate against RMB by 5% on the Company's other comprehensive income:

	Expected changes in other comprehensive income	
	As at 31 December 2018	As at 31 December 2017 (restated)
5% appreciation of HK\$	(2,555,097)	(2,274,767)
5% depreciation of HK\$	2,555,097	2,274,767

3.2.4 Interest rate risk

Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the market value of a financial instrument will fluctuate because of changes in market interest rates.

The Company takes on exposure to the effects of fluctuations in the prevailing levels of market interest rates on its financial position and cash flows.

The interest rate repricing risk for foreign currency denominated debt securities and the remaining part of the financial guarantees and credit commitments businesses which are not based upon these basic interest rates is not expected to be significant.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.4 Interest rate risk *(continued)*

The tables below summarize the Company's exposures to interest rate risks. The tables show the Company's assets and liabilities at carrying amounts, categorized by the earlier of contractual repricing or maturity dates.

	Up to 1 month	1 – 3 months	3 – 12 months	1 – 5 years	Over 5 years	Non-interest bearing	Total
As at 31 December 2018							
Assets							
Cash and balances with central bank	–	–	–	–	–	2,353,780	2,353,780
Due from banks and other financial institutions	14,626,550	10,075,887	380,000	–	–	–	25,082,437
Financial assets at fair value through profit or loss	–	20,821	544,483	–	–	1,290,050	1,855,354
Loans and advances to customers	56,489,616	7,140,491	1,117,481	1,147,727	1,793,404	–	67,688,719
Financial investments -financial assets at fair value through other comprehensive income	20,030,202	31,765,511	42,112,452	13,165,599	2,231,308	9,990	109,315,062
Other financial assets	–	–	–	–	–	1,429,059	1,429,059
Total financial assets	91,146,368	49,002,710	44,154,416	14,313,326	4,024,712	5,082,879	207,724,411
Liabilities							
Due to banks and other financial institutions	13,035,005	8,077,074	–	–	–	14,872	21,126,951
Financial liabilities at fair value through profit or loss	–	–	–	–	–	467,764	467,764
Due to customers	78,186,275	28,167,636	53,131,413	2,645	–	2,586,714	162,074,683
Other financial liabilities	–	–	–	–	–	5,280,872	5,280,872
Total financial liabilities	91,221,280	36,244,710	53,131,413	2,645	–	8,350,222	188,950,270
Total interest sensitivity gap	(74,912)	12,758,000	(8,976,997)	14,310,681	4,024,712	(3,267,343)	18,774,141

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.4 Interest rate risk *(continued)*

	Up to 1 month	1 – 3 months	3 – 12 months	1 – 5 years	Over 5 years	Non-interest bearing	Total
As at 31 December 2017 (restated)							
Assets							
Cash and balances with central bank	–	–	–	–	–	2,615,265	2,615,265
Due from banks and other financial institutions	71,196,667	7,516,100	19,395,027	–	–	7,747,415	105,855,209
Financial assets at fair value through profit or loss	3,163,005	742,327	1,221,015	4,754,419	1,328,125	9,081,422	20,290,313
Loans and advances to customers	201,364,287	41,239,675	10,681,367	1,526,497	1,554,682	2,000	256,368,508
Financial investments – available-for-sale	40,279,916	57,847,320	20,375,469	49,261,407	14,653,570	36,775	182,454,457
Financial investments – held-to-maturity	–	–	–	3,895,864	–	–	3,895,864
Other financial assets	–	–	–	–	–	5,008,562	5,008,562
Total financial assets	316,003,875	107,345,422	51,672,878	59,438,187	17,536,377	24,491,439	576,488,178
Liabilities							
Due to banks and other financial institutions	17,888,362	3,047,970	–	–	–	171,753	21,108,085
Financial liabilities at fair value through profit or loss	2,766,050	–	–	206,628	–	8,082,521	11,055,199
Due to customers	211,739,140	132,934,273	80,456,388	639,491	–	14,018,941	439,788,233
Certificates of deposit issued	578,704	9,946,185	4,683,140	6,806,689	–	–	22,014,718
Debt securities issued	5,848,936	26,611,075	480,073	5,948,583	–	–	38,888,667
Other financial liabilities	–	–	–	–	–	5,981,213	5,981,213
Total financial liabilities	238,821,192	172,539,503	85,619,601	13,601,391	–	28,254,428	538,836,115
Total interest sensitivity gap	77,182,683	(65,194,081)	(33,946,723)	45,836,796	17,536,377	(3,762,989)	37,652,063

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.5 Foreign exchange risk

The Company conducts the majority of its businesses in HK\$, with certain foreign transactions in USD, RMB and other currencies. The Company takes on exposure to the effects of fluctuations in the prevailing foreign exchange rates and changes on its financial position and cash flows. The senior management sets limits on the level of exposure in exchange rate risk and monitors the exposure regularly. The tables below summarize the Company's exposure to foreign exchange risk at the end of the year. The tables show the Company's total assets and liabilities in carrying amounts in HK\$, are categorized by the original currency.

	HK\$	RMB (HK\$ Equivalent)	USD (HK\$ Equivalent)	Others (HK\$ Equivalent)	Total
As at 31 December 2018					
Assets					
Cash and balances with central bank	2,298,318	37,534	12,390	5,538	2,353,780
Due from banks and other financial institutions	11,956,572	2,771,471	8,095,903	2,258,491	25,082,437
Financial assets at fair value through profit or loss	1,291,511	559,903	3,940	–	1,855,354
Loans and advances to customers	56,280,306	952,986	10,448,190	7,237	67,688,719
Financial investments -financial assets at fair value through other comprehensive income	10,358,704	51,101,942	32,422,542	15,431,874	109,315,062
Other financial assets	801,818	318,023	223,887	85,331	1,429,059
Total financial assets	82,987,229	55,741,859	51,206,852	17,788,471	207,724,411
Liabilities					
Due to banks and other financial institutions	3,643,886	11,793,287	5,650,743	39,035	21,126,951
Financial liabilities at fair value through profit or loss	438,633	12	29,119	–	467,764
Due to customers	96,528,813	21,630,426	35,937,504	7,977,940	162,074,683
Other financial liabilities	2,143,432	356,231	2,684,968	96,241	5,280,872
Total financial liabilities	102,754,764	33,779,956	44,302,334	8,113,216	188,950,270
Net position	(19,767,535)	21,961,903	6,904,518	9,675,255	18,774,141

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.5 Foreign exchange risk *(continued)*

	HK\$	RMB (HK\$ Equivalent)	USD (HK\$ Equivalent)	Others (HK\$ Equivalent)	Total
As at 31 December 2017 (restated)					
Assets					
Cash and balances with central banks	2,478,706	114,563	16,089	5,907	2,615,265
Due from banks and other financial institutions	29,566,292	6,124,750	58,736,755	11,427,412	105,855,209
Financial assets at fair value through profit or loss	3,720,921	10,050,490	5,167,179	1,351,723	20,290,313
Loans and advances to customers	151,788,388	4,334,501	97,966,667	2,278,952	256,368,508
Financial investments – available-for-sale	34,587,858	45,495,348	73,505,990	28,865,261	182,454,457
Financial investments – held-to-maturity	–	3,895,864	–	–	3,895,864
Other financial assets	1,418,238	1,559,681	1,696,041	334,602	5,008,562
Total financial assets	223,560,403	71,575,197	237,088,721	44,263,857	576,488,178
Liabilities					
Due to banks and other financial institutions	5,460,398	1,843,442	9,789,456	4,014,789	21,108,085
Financial liabilities at fair value through profit or loss	3,616,435	221,117	6,908,541	309,106	11,055,199
Due to customers	221,061,686	41,227,058	166,174,655	11,324,834	439,788,233
Certificates of deposit issued	6,534,929	6,859,906	8,619,883	–	22,014,718
Debt securities issued	859,393	1,680,254	36,349,020	–	38,888,667
Other financial liabilities	3,527,260	884,473	1,336,268	233,212	5,981,213
Total financial liabilities	241,060,101	52,716,250	229,177,823	15,881,941	538,836,115
Net position	(17,499,698)	18,858,947	7,910,898	28,381,916	37,652,063

3.2.6 Other price risk

The Company is exposed to other price risk arising from financial assets such as equity investments and derivatives linked to commodity price. The Company considers the exposure to the other price risk to be insignificant.

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk

3.3.1 Overview

Liquidity risk is the risk that the Company will be unable to meet its payment obligations associated with its financial liabilities when they fall due and other current liquidity needs. The consequence may be the failure to meet obligations to repay depositors and fulfill loan commitments for lending. The Company's objective in liquidity management is to ensure the availability of adequate funding to meet the demands of fund deposit withdrawals and other liabilities as they fall due and to ensure that it is able to meet its obligations to fund loan originations and commitments and to take advantage of new investment opportunities.

The Company is exposed to daily calls on its available cash resources from overnight deposits, current accounts, matured deposits, loan drawdowns, guarantees and from margin and other calls on cash settled derivatives.

3.3.2 Liquidity risk management process

Effective liquidity risk management helps to sustain the expansion of the Company's business with liquidity cost and risk under control. The Company has established and implemented its own liquidity risk management policy per local regulatory requirements in order to fulfill its liquidity risk management. The Asset and Liability Management Committee (ALCO) of the Company is the decision-making body in balance sheet management and is responsible for coordinating and overseeing all related strategies, including risk management framework and risk appetite. Asset and Liability Management Department is responsible for analyzing and monitoring activities related to liquidity risk. Global Markets Department is responsible for managing daily liquidity position and related executions. Internal Audit Department is responsible for conducting periodic review to ensure liquidity risk management framework is effectively implemented.

The cornerstone of the Company's funding sources is customer deposit. The Company strives to build up core deposits while diversifying funding sources via various funding channels to enhance financing capacity. Regarding liquidity arrangement with parent Company, the Company performs regular funding transfer with parent Company to preserve prompt intragroup backup funding supply if necessary. Monitoring and control on intragroup funding transactions are in line with those of third parties. Moreover, parent Company has set up groupwide internal limits to control the Company's reliance on parent Company's funding.

The majority of the liquidity risk of the Company arises from maturity mismatch of assets and liabilities. Therefore, regular cash flow analysis and projections on both on- and off-balance sheet items falling within different maturity buckets is performed to ensure funding need. Moreover, the Company closely monitors off-balance sheet funding obligations (such as commitments or letters of guarantee) and assesses their impact to our liquidity capacity. Furthermore, the Company strives to maintain high marketability of the asset portfolio to allow prompt monetization in case of unforeseeable liquidity crunch in the market.

The Company has in place various limits and indicators for liquidity risk, including liquidity coverage ratio, loan-to-deposit ratio, concentration limits on customer deposits, inter-company borrowing utilization ratio, etc. for effective identification and control of liquidity risk. The Company utilizes relevant management information systems to perform daily liquidity risk management functions. Moreover, the Company performs daily cash flow analysis to assess liquidity in normal circumstances, and performs regular stress test (at least monthly) to evaluate the Company's resilience under significant stress conditions. The stress test scenarios are designed with reference to the HKMA's Supervisory Policy Manuals, and also historical liquidity stress scenarios. The Company's stress test takes into account the impact of all assets, liabilities and off-balance sheet positions and estimates possible funding short-fall with historical data and plausible stress conditions. The results will be scrutinized and appropriate measures will be taken if necessary.

Notes to the Financial Statements

For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk *(continued)*

3.3.2 Liquidity risk management process *(continued)*

The Company has set up early warning indicator system, and movement of relevant indicators is closely monitored on a regular basis. In case of liquidity crisis emerges, the Company's Crisis Management Committee will be formed to formulate appropriate contingency funding plan to resolve the crisis. The Company also performs regular drill in order to ensure prompt actions and feasibility of contingency funding plan under crisis.

To cope with unpredictable liquidity needs, the Company has set up liquidity buffer to maintain sufficient highly liquid assets. The buffer portfolio contains cash, Exchange Fund Bills/Notes, unencumbered sovereign bonds and other high quality bonds, which is managed by Asset and Liability Management Department and operated by Global Markets Department on a daily basis.

3.3.3 Non-derivative financial instruments cash flows

The table below presents the cash flows of the Company related to non-derivative financial liabilities (including accrued interest) by remaining contractual maturities at the end of the reporting date. The amounts disclosed in the tables are undiscounted contractual cash flows. The Company's expected cash flows on these financial instruments may vary significantly from the following analysis. For example, demand deposits from customers are expected to maintain a stable or increasing balance although they have been classified as repayable on demand in the following tables.

	On Demand	Up to 1 month	1 – 3 months	3 – 12 months	1 – 5 years	Over 5 years	Overdue	Undated	Total
As at 31 December 2018									
Financial liabilities									
Due to banks and other financial institutions	1,151,931	9,927,788	8,118,841	-	-	2,003,944	-	-	21,202,504
Due to customers	58,493,481	22,289,469	28,217,512	53,373,532	2,676	-	-	-	162,376,670
Other financial liabilities	279,842	4,399,196	235,300	340,990	12	14,591	-	-	5,269,931
Total financial liabilities	59,925,254	36,616,453	36,571,653	53,714,522	2,688	2,018,535	-	-	188,849,105

	On Demand	Up to 1 month	1 – 3 months	3 – 12 months	1 – 5 years	Over 5 years	Overdue	Undated	Total
As at 31 December 2017 (restated)									
Financial liabilities									
Due to banks and other financial institutions	2,166,897	17,038,621	3,047,970	-	-	-	-	-	22,253,488
Non-derivative financial liabilities at fair value through profit or loss	-	2,767,000	-	5,071	208,607	-	-	-	2,980,678
Due to customers	1,775,300	224,372,055	133,376,500	80,893,518	643,089	-	-	-	441,060,462
Certificate of deposits issued	-	579,636	6,850,496	7,259,995	7,877,490	-	-	-	22,567,617
Debt securities issued	-	5,867,912	-	496,999	34,654,403	-	-	-	41,019,314
Other financial liabilities	1,550,715	3,168,032	736,934	512,641	3,625	-	-	-	5,971,947
Total financial liabilities	5,492,912	253,793,256	144,011,900	89,168,224	43,387,214	-	-	-	535,853,506

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk *(continued)*

3.3.4 Derivative financial instruments cash flows

The Company's derivative financial instruments are either settled on a net basis or a gross basis.

The Company's derivative financial instruments that will be settled on a net basis mainly include interest rate swaps, forward rate agreements and others, whereas derivative financial instruments that will be settled on a gross basis mainly include currency forward and currency swaps.

The table below analyses the cash flows of the Company by remaining contractual period as at the reporting date. The amounts disclosed in the table are the contractual undiscounted cash flows.

	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
As at 31 December 2018						
Derivative financial instruments settled on net basis	1,285	597	18,534	(43,780)	(5,491)	(28,855)
Derivative financial instruments settled on a gross basis						
– Outflow	(72,948,707)	(29,354,422)	(82,027,870)	(4,032,556)	–	(188,363,555)
– Inflow	73,077,909	29,305,793	82,758,922	4,029,869	–	189,172,493
Total	129,202	(48,629)	731,052	(2,687)	–	808,938
	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
As at 31 December 2017 (restated)						
Derivative financial instruments settled on net basis	9,086	80,863	254,834	53,311	17,380	415,474
Derivative financial instruments settled on a gross basis						
– Outflow	(206,446,960)	(126,346,985)	(169,319,751)	(16,400,738)	–	(518,514,434)
– Inflow	206,923,743	126,420,522	169,060,530	16,499,515	–	518,904,310
Total	476,783	73,537	(259,221)	98,777	–	389,876

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For the year ended 31 December 2018
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk *(continued)*

3.3.5 Maturity analysis

The table below analyses the Company's assets and liabilities into relevant maturity groupings based on the remaining period at the end of reporting date to the contractual maturity date.

	On demand	Up to 1 month	1 – 3 months	3 – 12 months	1 – 5 years	Over 5 years	Overdue	Undated	Total
As at 31 December 2018									
Assets									
Cash and balances with central banks	2,353,780	-	-	-	-	-	-	-	2,353,780
Due from banks and other financial institutions	8,669,337	4,263,724	1,081,473	380,000	10,687,903	-	-	-	25,082,437
Loans and advances to customers	1,464,922	1,064,537	208,405	6,727,289	25,424,400	32,527,079	272,087	-	67,688,719
Financial assets at fair value through profit or loss	-	296,837	57,126	1,495,340	6,051	-	-	-	1,855,354
Financial investments – financial assets at fair value through other comprehensive income	-	4,368,036	6,512,334	48,934,349	46,776,451	2,713,902	-	9,990	109,315,062
Other financial assets	28,594	11,391	16,946	927,387	347,503	87,434	9,804	-	1,429,059
Total financial assets	12,516,633	10,004,525	7,876,284	58,464,365	83,242,308	35,328,415	281,891	9,990	207,724,411
Liabilities									
Due to banks and other financial institutions	1,151,931	9,897,946	8,077,074	-	-	2,000,000	-	-	21,126,951
Financial liabilities at fair value through profit or loss	-	163,216	69,998	202,735	19,746	12,069	-	-	467,764
Due to customers	58,493,481	22,279,509	28,167,636	53,131,413	2,644	-	-	-	162,074,683
Other financial liabilities	282,768	4,402,217	235,486	342,233	614	17,554	-	-	5,280,872
Total financial liabilities	59,928,180	36,742,888	36,550,194	53,676,381	23,004	2,029,623	-	-	188,950,270
Net amount on liquidity gap	(47,411,547)	(26,738,363)	(28,673,910)	4,787,984	83,219,304	33,298,792	281,891	9,990	18,774,141

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3 FINANCIAL RISK MANAGEMENT (continued)

3.3 Liquidity risk (continued)

3.3.5 Maturity analysis (continued)

	On demand	Up to 1 month	1 – 3 months	3 – 12 months	1 – 5 years	Over 5 years	Overdue	Undated	Total
As at 31 December 2017 (restated)									
Assets									
Cash and balances with central banks	2,615,265	–	–	–	–	–	–	–	2,615,265
Due from banks and other financial institutions	6,759,715	72,184,366	7,516,100	19,395,028	–	–	–	–	105,855,209
Loans and advances to customers	127,214	41,500,930	25,877,103	53,882,576	96,179,848	35,455,646	3,345,191	–	256,368,508
Financial assets at fair value through profit or loss	–	5,535,550	2,532,786	4,213,670	6,497,373	1,510,934	–	–	20,290,313
Financial investments – available-for-sale	–	19,446,217	21,028,072	34,951,559	91,034,298	15,957,537	–	36,774	182,454,457
Financial investments – held-to-maturity	–	–	–	–	3,895,864	–	–	–	3,895,864
Other financial assets	23,793	3,422,283	878,987	660,994	221	–	22,284	–	5,008,562
Total financial assets	9,525,987	142,089,346	57,833,048	113,103,827	197,607,604	52,924,117	3,367,475	36,774	576,488,178
Liabilities									
Due to banks and other financial institutions	2,175,967	15,884,148	3,047,970	–	–	–	–	–	21,108,085
Financial liabilities at fair value through profit or loss	5,215,044	1,781,772	2,836,561	1,144,184	77,638	–	–	–	11,055,199
Due to customers	3,293,434	224,390,601	131,402,640	80,062,068	639,490	–	–	–	439,788,233
Certificates of deposit issued	–	578,704	6,809,415	7,211,960	7,414,639	–	–	–	22,014,718
Debt securities issued	–	5,848,936	–	480,073	32,559,658	–	–	–	38,888,667
Other financial liabilities	19,082	2,782,979	2,268,566	906,961	3,625	–	–	–	5,981,213
Total financial liabilities	10,703,527	251,267,140	146,365,152	89,805,246	40,695,050	–	–	–	538,836,115
Net amount on liquidity gap	(1,177,540)	(109,177,794)	(88,532,104)	23,298,581	156,912,554	52,924,117	3,367,475	36,774	37,652,063

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk *(continued)*

3.3.6 Off-balance sheet items

The table below lists the off-balance sheet items of the Company according to their remaining period to the contractual maturity date. Financial guarantees are included at notional amounts and based on the earliest contractual maturity date.

	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total
As at 31 December 2018					
Loan commitments and credit related commitments	7,872,156	1,344,434	125,905	2,597,322	11,939,817
Guarantees, acceptances and letters of credit	158,236	22,778	200	667	181,881
Total	8,030,392	1,367,212	126,105	2,597,989	12,121,698
	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total
As at 31 December 2017 (restated)					
Loan commitments and credit related commitments	11,967,477	756,482	16,674,200	457,108	29,855,267
Guarantees, acceptances and letters of credit	7,639,588	4,834,678	97,398	1,013	12,572,677
Total	19,607,065	5,591,160	16,771,598	458,121	42,427,944

3.4 Fair value of financial assets and liabilities

(a) Determination of fair value and valuation techniques

Certain financial assets and liabilities of the Company are measured at fair value or with fair value disclosed for financial reporting purposes. The fair value has been determined using appropriate valuation techniques and inputs for fair value measurements. The appropriateness of the valuation techniques and the inputs to the fair value measurements are reviewed periodically.

Fair value measurements are categorized into Level 1, 2 or 3 based on the degree to which the inputs to the fair value measurements are observable and the significance of the inputs to the fair value measurement in its entirety, which are described as follows:

Level 1: The fair value of financial instruments traded in active markets is based on quoted (unadjusted) market prices at the end of the reporting period. The quoted market price used for financial assets held by the Company is the current bid price. These instruments are included in level 1.

Level 2: The fair value of financial instruments that are not traded in an active market is determined using valuation techniques. These valuation techniques maximize the use of observable market data where it is available and rely as little as possible on entity specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in level 2.

Level 3: If one or more of the significant inputs is not based on observable market data, the instrument is included in level 3.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.4 Fair value of financial assets and liabilities *(continued)*

(a) Determination of fair value and valuation techniques (continued)

Specific valuation techniques used to value for Level 2 financial instruments include:

- The use of quoted market prices or dealer quotes for similar instruments.
- Calculation of the present value of the estimated future cash flows based on observable yield curves for interest rate swaps.
- The fair value of foreign currency forwards is determined using forward exchange rates at the balance sheet date.
- The fair value of the remaining financial instruments is determined using discounted cash flow analysis.

(b) Financial instruments not measured at fair value

The table below summarizes the carrying amounts and fair values where there are obvious variances from the carrying amounts, of those financial assets and liabilities that are not presented on the statement of financial position at their fair value.

	As at 31 December 2018		As at 31 December 2017 (restated)	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Financial investment – held-to-maturity	N.A.	N.A.	3,895,864	3,872,640
Financial investment – available-for-sale equity securities	N.A.	N.A.	36,774	19,968
Financial liabilities				
Certificates of deposit issued	–	–	8,178,169	8,181,934
Debt securities issued	–	–	17,310,104	17,364,566

Fair value hierarchy of financial instruments not measured at fair value

	Level 1	Level 2	Level 3	Total
As at 31 December 2018				
Financial assets				
Financial investments -Financial assets at amortized cost	–	–	–	–
Financial liabilities				
Certificates of deposit issued	–	–	–	–
Debt securities issued	–	–	–	–
As at 31 December 2017 (restated)				
Financial assets				
Financial investments – held-to-maturity	3,872,640	–	–	3,872,640
Financial investments – available-for-sale equity securities	–	19,968	–	19,968
Financial liabilities				
Certificates of deposit issued	1,456,011	6,725,923	–	8,181,934
Debt securities issued	1,680,255	15,684,311	–	17,364,566

Other financial instruments not carried at fair value are typically short-term in nature or repriced to current market rates frequently. Accordingly, their carrying amounts are reasonable approximations of their fair values.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.4 Fair value of financial assets and liabilities *(continued)*

(c) Financial assets and financial liabilities measured at fair value on a recurring basis

The table below summarizes the information relating to the fair value hierarchy of the financial assets and financial liabilities measured at fair value on a recurring basis:

	Level 1	Level 2	Level 3	Total
As at 31 December 2018				
Financial assets at fair value through profit or loss				
Debt securities				
– Governments and central banks	544,483	–	–	544,483
– Banks and other financial institutions	20,821	–	–	20,821
Derivative financial instruments				
– Foreign exchange contracts	–	1,284,902	–	1,284,902
– Interest rate contracts and others	–	5,148	–	5,148
	565,304	1,290,050	–	1,855,354
Financial investments – financial assets at fair value through other comprehensive income				
Debt securities at fair value through other comprehensive income				
– Governments and central banks	14,914,288	–	–	14,914,288
– Banks and other financial institutions	67,974,051	25,945,556	–	93,919,607
– Corporate entities	471,177	–	–	471,177
Equity securities at fair value through other comprehensive income				
– Banks and other financial institutions	–	9,990	–	9,990
	83,359,516	25,955,546	–	109,315,062
Total assets	83,924,820	27,245,596	–	111,170,416
Financial liabilities at fair value through profit or loss				
Derivative financial instruments				
– Foreign exchange contracts	–	438,645	–	438,645
– Interest rate contracts and others	–	29,119	–	29,119
Total liabilities	–	467,764	–	467,764

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.4 Fair value of financial assets and liabilities *(continued)*

(c) Financial assets and financial liabilities measured at fair value on a recurring basis (continued)

	Level 1 (restated)	Level 2 (restated)	Level 3 (restated)	Total (restated)
As at 31 December 2017				
Financial assets at fair value through profit or loss				
Debt securities				
– Governments and central banks	6,102,978	39,453	–	6,142,431
– Public sector entities	105,267	–	–	105,267
– Banks and other financial institutions	3,067,686	–	–	3,067,686
– Corporate entities	1,893,507	–	–	1,893,507
Derivative financial instruments				
– Foreign exchange contracts	–	7,877,246	–	7,877,246
– Interest rate contracts and others	–	1,204,176	–	1,204,176
	11,169,438	9,120,875	–	20,290,313
Financial investment – available-for-sale				
Debt securities at fair value through other comprehensive income				
– Governments and central banks	11,609,924	124,377	–	11,734,301
– Public sector entities	193,833	–	–	193,833
– Banks and other financial institutions	100,254,066	49,724,686	–	149,978,752
– Corporate entities	20,510,797	–	–	20,510,797
	132,568,620	49,849,063	–	182,417,683
Total assets	143,738,058	58,969,938	–	202,707,996
Financial liabilities at fair value through profit or loss				
Short position of securities held for trading	2,972,678	–	–	2,972,678
Derivative financial instruments				
– Foreign exchange contracts	–	7,242,761	–	7,242,761
– Interest rate contracts and others	–	839,760	–	839,760
Certificates of deposit issued	5,409,148	8,427,401	–	13,836,549
Debt securities issued	–	21,578,563	–	21,578,563
Total liabilities	8,381,826	38,088,485	–	46,470,311

There was no transfer between level 1 and 2 during the year.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.5 Offsetting financial assets and financial liabilities

Certain financial assets and financial liabilities of the Company are subject to enforceable master netting arrangements or similar agreements. The agreement between the Company and the counterparty generally allows for net settlement of the relevant financial assets and financial liabilities when both elect to settle on a net basis. In the absence of such a mutual consent, financial assets and financial liabilities will be settled on a gross basis. However, each party to the master netting arrangements or similar agreements will have the option to settle all such amounts on a net basis in the event of default of the other party. These financial assets and financial liabilities of the Company are not offset in accordance with HKFRS.

The following table presents the recognized financial instruments that are offset, or subject to enforceable master netting arrangements and other similar agreements but not offset, as at 31 December 2018 and 31 December 2017. The column 'net amount' shows the impact on the Company's statement of financial position if all set-off rights were exercised.

	Gross amounts of recognized financial assets	Gross amounts of recognized financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position	Related amounts not offset		Net amount
				Financial instruments (including non-cash collateral)	Cash collateral received	
2018						
Financial assets						
Derivative financial instruments	1,166,681	-	1,166,681	(448,378)	(219,325)	498,978
Total	1,166,681	-	1,166,681	(448,378)	(219,325)	498,978
	Gross amounts of recognized financial liabilities	Gross amounts of recognized financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position	Related amounts not offset		Net amount
				Financial instruments (including non-cash collateral)	Cash collateral advanced	
Financial liabilities						
Derivative financial instruments	452,550	-	452,550	(448,378)	(930)	3,242
Total	452,550	-	452,550	(448,378)	(930)	3,242

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT (continued)

3.5 Offsetting financial assets and financial liabilities (continued)

	Gross amounts of recognized financial assets	Gross amounts of recognized financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position	Related amounts not offset		Net amount
				Financial instruments (including non- cash collateral)	Cash collateral received	
2017 (restated)						
Financial assets						
Derivative financial instruments	7,850,850	–	7,850,850	(4,942,809)	(14,027)	2,894,014
Debt securities at fair value through profit or loss	232,979	–	232,979	(211,362)	–	21,617
Financial investments – financial assets at fair value through other comprehensive income	7,544,872	–	7,544,872	(7,173,187)	–	371,685
Total	15,628,701	–	15,628,701	(12,327,358)	(14,027)	3,287,316

	Gross amounts of recognized financial liabilities	Gross amounts of recognized financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position	Related amounts not offset		Net amount
				Financial instruments (including non- cash collateral)	Cash collateral advanced	
Financial liabilities						
Derivative financial instruments	7,701,278	–	7,701,278	(4,942,809)	(47,585)	2,710,884
Financial assets sold under repurchase agreements	7,384,549	–	7,384,549	(7,384,549)	–	–
Total	15,085,827	–	15,085,827	(12,327,358)	(47,585)	2,710,884

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.6 Capital management

The Company's objectives in managing "capital", which is a broader concept than the "shareholder equity" on the statement of financial position, are:

- To comply with the capital requirements set by the regulators of the markets where the Company operates;
- To ensure the Company's ability to maintain a stable operation so as to continue provide returns for shareholders and benefits for other stakeholders; and
- To maintain a strong capital base to support the development of its business.

Consistent with industry practice, the Company monitors its capital structure on the basis of the capital adequacy ratio and there have been no material changes in the Company's policy on the management of capital during the year.

The Company has complied with all externally imposed capital requirements during 2018.

4 NET INTEREST INCOME

	2018	2017 (restated)
Interest income		
Due from banks and other financial institutions	933,600	1,939,381
Loans and advances to customers	1,679,549	5,510,462
Financial investments	2,200,059	5,370,233
Others	884	7,263
	4,814,092	12,827,339
Interest expense		
Due to banks and other financial institutions	(360,719)	(1,263,666)
Due to customers	(2,476,770)	(5,231,753)
Debt securities and certificates of deposit issued	(119,347)	(1,268,292)
Others	(429)	(3,441)
	(2,957,265)	(7,767,152)
Net interest income	1,856,827	5,060,187

Notes to the Financial Statements

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5 FEE AND COMMISSION INCOME

	2018	2017 (restated)
Settlement service	45,137	80,902
Interchange service	34,929	29,238
Credit facilities, guarantee and commitment	85,777	829,203
Agency service	542,169	667,774
Depository service	59,095	55,722
Others	10,577	80,986
	777,684	1,743,825
Of which arise from:		
Financial assets/liabilities not at fair value through profit or loss	74,513	176,867
Trust and other fiduciary activities	87,420	89,637

6 FEE AND COMMISSION EXPENSE

	2018	2017 (restated)
Settlement and brokerage service	28,826	60,901
Interchange service	9,748	11,966
Others	6,454	11,654
	45,028	84,521
Of which arise from:		
Financial assets/liabilities not at fair value through profit or loss	9,748	11,966

7 DIVIDEND INCOME

	2018	2017 (restated)
Financial investments – financial assets at fair value through other comprehensive income – unlisted investments	700	–
Financial investments – available-for-sale equity securities	–	2,980

Notes to the Financial Statements

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8 NET GAINS ARISING FROM TRADING ACTIVITIES

	2018	2017 (restated)
Foreign exchange	175,895	1,121,233
Interest rate instruments and others	318,332	(114,699)
Debt securities at fair value through profit or loss (2017: Trading securities)	(127,405)	(221,123)
	366,822	785,411

Net gains on foreign exchange include gains or losses from the trading of spot and forward contracts, currency swaps, cross currency interest rate swaps, currency options and the translation of foreign currency monetary assets and liabilities into HK\$.

Net gains on interest rate instruments and others include trading gains and losses and fair value changes of interest rate swaps, interest rate options and other derivatives.

Net gains arising from trading activities for the year ended 31 December 2018 include a gain of HK\$1,703,000 (2017: HK\$29,215,000) in relation to changes in the fair value of financial liabilities designated at fair value through profit or loss.

9 OTHER OPERATING INCOME

	2018	2017 (restated)
Revaluation of investment properties	–	48,520
Rental income	1,258	15,557
Management fee from a branch of the ultimate holding company (Note 34)	6,684	–
Others	13,040	46,112
	20,982	110,189

Others mainly include income arising from miscellaneous banking services provided to the Company's customers.

Notes to the Financial Statements

For the year ended 31 December 2018
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10 CHANGE IN EXPECTED CREDIT LOSSES/CHARGES ON IMPAIRMENT ALLOWANCES

	2018	2017 (restated)
Loans and advances to customers		
Changes in ECL allowance		
– new charges	204,710	N.A.
– recoveries	(79,800)	N.A.
	124,910	N.A.
Reversal of impairment allowance – Individually assessed		
– new charges	N.A.	60,730
– recoveries	N.A.	(63,190)
	N.A.	(2,460)
Provision for impairment allowance – Collectively assessed		
– new charges	N.A.	120,000
– recoveries	N.A.	(2,389)
	N.A.	117,611
Recovery of financial investments previously written off	–	(31,104)
Provision for impairment allowances on other receivables	N.A.	17,811
Changes in ECL allowances:		
– financial investments	67,899	N.A.
– other receivables	21,563	N.A.
– due from banks and other financial institutions	11,586	N.A.
– financial guarantee and credit related commitment	(13,369)	N.A.
	87,679	(13,293)
	212,589	101,858

Notes to the Financial Statements

For the year ended 31 December 2018
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11 OTHER OPERATING EXPENSES

	2018	2017 (restated)
Staff costs		
– salaries and other allowances	529,014	1,281,261
– retirement benefit costs (Note 12)	35,294	79,909
Loss on disposal of property and equipment	2,183	–
General operational and administrative expenses	215,094	389,113
Depreciation and amortization	33,154	87,865
Auditor's remuneration	4,200	275
Buildings administration fee	11,973	38,037
Rental expenses	209,870	228,817
Repairs and maintenance	46,657	124,721
Printing, postage and telegram	62,711	115,128
Withholding tax	59,363	–
Directors', senior management's and key personnel's emoluments	18,881	62,796
Management fee to a branch of the ultimate holding company	259,738	–
Others	15,640	23,793
	1,503,772	2,431,715

12 RETIREMENT BENEFIT COSTS

	2018	2017 (restated)
Pension costs – defined contribution plans	35,294	79,909

Notes to the Financial Statements

For the year ended 31 December 2018
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13 BENEFITS AND INTEREST OF DIRECTORS (DISCLOSURES REQUIRED BY SECTION 383 OF THE COMPANIES ORDINANCE (CAP. 622) AND COMPANIES (DISCLOSURE OF INFORMATION ABOUT BENEFITS OF DIRECTORS) REGULATION (CAP. 622G)

(a) Directors' emoluments

Details of the emoluments paid to or receivable by the directors of the Company in respect of their services rendered for the Company are as follows:

	2018	2017 (restated)
Directors' fees	1,513	1,238
Salaries, allowances and benefits in kind	817	–
Bonuses	852	–
Retirement benefit costs	17	–
	3,199	1,238

For the year ended 31 December 2018 and 2017, some of the executive directors of the Company receive emoluments from HKBR in respect of their services to the Company and HKBR. Before recapitalization of business, no apportionment has been made as the Company did not commence business and the portion of the executive directors' services in relation to the Company is considered immaterial.

After recapitalization of business, some of the executive directors received emoluments and emoluments receivable from HKBR, amounting to HK\$12,514,000, in respect of their service to the Company and HKBR. The portion of the directors' emoluments in relation to the services to the Company of HK\$8,346,000 has been charged by HKBR and included in management fee to a branch of the ultimate holding company (Note 11).

(b) Directors' material interests in transactions, arrangements or contracts

No significant transactions, arrangements and contracts in relation to the Company's business to which the Company was a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

Notes to the Financial Statements

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14 INCOME TAX EXPENSES

	2018	2017 (restated)
Current tax		
– Hong Kong profits tax	284,049	869,020
– Under/(over) provision in prior years	23,980	(766)
– Others	–	(5,005)
	308,029	863,249
Deferred income tax	(39,271)	(25,213)
Income tax expense	268,758	838,036

The current tax provision for the year ended 31 December 2018 and 2017 is based on the estimated assessable profit by using the Hong Kong profits tax rate of 16.5 per cent. The major reconciliation items are as follows:

	2018	2017 (restated)
Profit before tax	1,251,775	5,231,214
Tax calculated at a tax rate of 16.5%	206,543	863,150
Tax effect of tax losses not recognized	–	956
Tax effect of expense not deductible for tax purpose	32,699	501
Tax effect arising from income not subject to tax	(4,366)	(11,324)
Under/(over) provision in prior years	23,980	(766)
Utilization of tax loss previously not recognized	(1,246)	–
Others	11,148	(14,481)
	268,758	838,036

15 CASH AND BALANCES WITH CENTRAL BANK

	2018	2017 (restated)
Cash	411,344	455,883
Balances with central bank	1,942,436	2,159,382
	2,353,780	2,615,265

Notes to the Financial Statements

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16 DUE FROM BANKS AND OTHER FINANCIAL INSTITUTIONS

	2018	2017 (restated)
Due from banks and other financial institutions	8,669,382	6,859,224
Placements with and loans to banks	16,419,140	98,995,985
Less: ECL allowances	(6,085)	N. A.
	25,082,437	105,855,209

17 FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

	2018	2017 (restated)
Derivative financial instruments (Note 18)	1,290,050	9,081,422
Debt securities at fair value through profit or loss		
Government bonds		
– Listed in Hong Kong	–	2,888,319
– Listed outside Hong Kong	–	138,159
– Unlisted	544,483	3,115,953
Other debt securities		
– Listed in Hong Kong	–	3,219,601
– Listed outside Hong Kong	–	1,700,861
– Unlisted – banking sector	20,821	145,998
	1,855,354	20,290,313

Debt securities at fair value through profit or loss are analyzed by issuer as follows:

	2018	2017 (restated)
Debt securities at fair value through profit or loss		
– Governments and central banks	544,483	6,142,431
– Public sector entities	–	105,267
– Banks and other financial institutions	20,821	3,067,686
– Corporate entities	–	1,893,507
	565,304	11,208,891

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17 FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS *(continued)*

The table below presents an analysis of debt investment at fair value through profit or loss by independent rating agencies designation as at 31 December 2018 and 2017:

	2018	2017
	Financial assets at fair value through profit or loss (debt securities)	Financial assets at fair value through profit or loss (debt securities) (restated)
HK\$ securities		
AAA	–	–
AA- to AA+	–	247,095
A- to A+	–	–
Below A-	–	–
Unrated (1)	5,412	3,173,091
Sub-total	5,412	3,420,186
Foreign currency securities		
AAA	–	84,750
AA- to AA+	–	105,267
A- to A+	20,821	4,108,673
Below A-	–	1,385,172
Unrated (1)	539,071	2,104,843
Sub-total	559,892	7,788,705
Total	565,304	11,208,891

Note 1: These mainly represent investments and trading securities issued by Ministry of Finance of the PRC (“MOF”) and the People’s Bank of China (“PBOC”) which are not rated by independent agencies.

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18 DERIVATIVE FINANCIAL INSTRUMENTS

The following derivative instruments are utilized by the Company for trading or hedging purposes:

Currency forwards are contracts between two parties to buy or sell certain currencies at a specified future date at a predetermined price. The party agreeing to buy the underlying currency in the future assumes a long position, and the party agreeing to sell the currency in the future assumes a short position. The price agreed upon is called the delivery price, which is equal to the forward price at the time the contract is entered into.

Currency and interest rate swaps are commitments to exchange one set of cash flows for another. Swaps result in an economic exchange of currencies or interest rates (for example, fixed rate for floating rate) or a combination of all these (i.e. cross-currency interest rate swaps). The Company's credit risk represents the potential cost to replace the swap contracts if counterparties fail to perform their obligation. This risk is monitored on an ongoing basis with reference to the current fair value, the notional amount of the contracts and the liquidity of the market. To control the level of credit risk taken, the Company assesses counterparties using the same techniques as for its lending activities.

Currency and interest rate options are contractual agreements under which the seller (writer) grants the purchaser (holder) the right, but not the obligation, either to buy (a call option) or sell (a put option), on or before a set date or during a set period, a specific amount of a foreign currency at a predetermined price or to receive an interest payment based on a variable interest rate and pay a fixed interest rate or vice versa. The seller receives a premium from the purchaser in consideration for assuming foreign exchange or interest rate risk. Options may be either exchange-traded or negotiated between the Company and a customer (over the-counter market).

The notional amounts of certain types of financial instruments provide a reference of the amounts recognized in the statement of financial position but do not necessarily indicate the amounts of future cash flows involved or the current fair value of the instruments and, therefore, do not indicate the Company's exposure to credit or price risks. The derivative instruments become favourable (assets) or unfavourable (liabilities) as a result of fluctuations in market interest rates or foreign exchange rates relative to their terms. The aggregate fair values of derivative financial assets and liabilities can fluctuate significantly from time to time. The fair values of derivative instruments held are set out in the following tables.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

18 DERIVATIVE FINANCIAL INSTRUMENTS *(continued)*

	For hedging			For trading			Total		
	Contractual/ notional amount	Fair values		Contractual/ notional amount	Fair values		Contractual/ notional amount	Fair values	
		Assets	Liabilities		Assets	Liabilities		Assets	Liabilities
As at 31 December 2018									
Foreign exchange contracts	-	-	-	189,963,423	1,284,902	(438,645)	189,963,423	1,284,902	(438,645)
Interest rate contracts and others	4,157,440	5,148	(29,119)	-	-	-	4,157,440	5,148	(29,119)
Total amount of derivative instruments recognized	4,157,440	5,148	(29,119)	189,963,423	1,284,902	(438,645)	194,120,863	1,290,050	(467,764)
As at 31 December 2017 (restated)									
Foreign exchange contracts	1,440,218	64,385	-	564,792,478	7,812,861	(7,242,761)	566,232,696	7,877,246	(7,242,761)
Interest rate contracts and others	44,456,709	555,514	(133,070)	243,034,994	648,662	(706,690)	287,491,703	1,204,176	(839,760)
Total amount of derivative instruments recognized	45,896,927	619,899	(133,070)	807,827,472	8,461,523	(7,949,451)	853,724,399	9,081,422	(8,082,521)

The tables above provide a breakdown of the contractual or notional amounts and the fair values of the Company's derivative financial instruments outstanding at year end. These instruments, comprising foreign exchange and interest rate derivatives allow the Company and its customers to transfer, modify or reduce their foreign exchange and interest rate risks.

The Company undertakes its transactions in foreign exchange and interest rates contracts with other financial institutions and customers. Management has established limits for these contracts based on counterparty types, industry sectors and countries. Related risks are regularly monitored and controlled by management.

Notional amounts of derivative financial instruments by original currency:

	2018	2017 (restated)
Renminbi	46,222,232	214,078,862
United States Dollar	95,597,519	386,099,482
Hong Kong Dollar	48,663,814	229,207,873
Others	3,637,298	24,338,182
Total	194,120,863	853,724,399

Notes to the Financial Statements

For the year ended 31 December 2018
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18 DERIVATIVE FINANCIAL INSTRUMENTS *(continued)*

Hedge accounting

The Company applies hedge accounting on hedging its interest rate risk on certain bond investments, as follows:

Interest rate risk on fixed rate financial assets (fair value hedge)

The Company holds a portfolio of long-term fixed rate debt securities and therefore is exposed to changes in fair value due to movements in market rates. The Company manages this risk exposure by entering into pay fixed/receive floating interest rate swaps.

Only the interest rate risk element is hedged and therefore other risks, such as credit risk, are managed but not hedged by the Company. The interest rate risk component is determined as the change in fair value of the long-term fixed rate debt securities arising solely from changes in the benchmark rate of interest. Such changes are usually the largest component of the overall change in fair value.

This strategy is designated as a fair value hedge and its effectiveness is assessed by comparing changes in the fair value of the debt securities attributable to changes in the benchmark rate of interest with changes in the fair value of the interest rate swaps.

The Company establishes the hedging ratio by matching the notional of the derivatives with the principal of the portfolio being hedged. Following reasons could cause ineffectiveness:

- 1) Differences between the expected and actual holding amount, as the Company hedges to the expected maturity date but may sell the bond investment according to trading strategies;
- 2) The credit risk of the counterparty impacts the fair value of interest rate swaps, but has no impacts on hedged items.

Foreign exchange risk on foreign currency debt (cash flow hedge)

The Company obtain effective sources of funding from international markets. As part of this process, the Company assumes significant foreign currency exposure, principally CNY. The foreign currency risk component is then managed and mitigated by the use of foreign exchange contracts. These instruments are entered into to match the maturity profile of estimated repayments of the Company's debt instruments. This hedging strategy is applied to the portion of the exposure that is not naturally offset against matching asset positions held by the Company in financial investments also denominated in foreign currencies.

The foreign currency risk component is determined as the change in cash flows of the foreign currency debt arising solely from changes in the relevant foreign currency forward exchange rate. Such changes constitute a significant component of the overall changes in cash flows of the instrument.

The effectiveness of this strategy is assessed by comparing the changes in fair value of the foreign exchange contracts with changes in fair value of the hedged liabilities attributable to the hedged.

The Company establishes the hedging ratio by matching the notional of the derivatives with the principal of the portfolio being hedged. Following reasons could cause ineffectiveness:

- 1) Differences between the expected and actual volume of prepayments, as the Company hedges to the expected repayment date taking into account expected prepayments based on past experience;
- 2) The credit risk of the counterparty impacts the fair value of foreign exchange swaps, but has no impacts on hedged items.

Notes to the Financial Statements

For the year ended 31 December 2018
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18 DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Hedge accounting (continued)

a) The following table sets out the maturity profile and average interest rate of the hedging instruments used in the Company's hedging strategies:

As at 31 December 2018	Maturity					Total
	Up to one month	One to three months	Three months to one year	One year to five years	More than five years	
Fair value hedge						
Interest rate						
Interest rate contract						
Notional	–	–	782,945	2,810,774	563,721	4,157,440
Average fixed interest rate	–	–	2%	2.76%	4.35%	2.73%

As at 31 December 2018, there is no derivative under cash flow hedge.

b) The following table contains details of the hedging instruments used in the Company's hedging strategies:

As at 31 December 2018	Carrying amount			Line item on statement of financial position	Fair value changes of the hedging instruments
	Notional	Assets	Liabilities		
Fair value hedge					
Interest rate					
Interest rate contract	4,157,440	5,148	(29,119)	Financial assets/ liabilities at fair value through profit or loss	(23,971)

As at 31 December 2018, there is no derivative under cash flow hedge.

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For the year ended 31 December 2018
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18 DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Hedge accounting (continued)

c) The following table contains details of the hedged exposures covered by the Company's hedging strategies:

As at 31 December 2018	Carrying amount of hedged item	Accumulated amount of fair value adjustments on the hedged item	Line item on statement of financial position	Fair value changes of the hedged items	Ineffectiveness recognized in profit or loss
Fair value hedge					
Interest rate					
Debt investments	4,184,685	25,302	Financial investments – fair value through other comprehensive income	25,302	(124)

As at 31 December 2018, there is no derivative under cash flow hedge.

The following table contains information regarding the effectiveness of the hedging relationships designated by the Company, as well as the impacts on profit or loss and other comprehensive income:

For the year ended 31 December 2018	Gains/(losses) recognized in other comprehensive Income	Hedge ineffectiveness recognized in profit and loss	Profit and loss line item that includes hedge ineffectiveness
Fair value hedge			
Interest rate	–	(124)	Net gains arising from trading activities

For the year ended 31 December 2018, the Company's net loss arising from cash flow hedge of HK\$529,000 were recognized in other comprehensive income. The gain and loss arising from ineffective portion of cash flow hedge recorded in net gains arising from trading activities was immaterial. The amount reclassified from reserve to profit and loss was nil.

The derivative financial instruments include those designated as hedging instruments by the Company in 2017 as follows:

As at 31 December 2017 (restated)	Contractual/ notional amount	Fair values	
		Assets	Liabilities
Derivative financial instruments designated as hedging instruments in cash flow hedges	1,440,218	64,385	–
Derivative financial instruments designated as hedging instruments in fair value hedges	44,456,709	555,514	(133,070)
Total	45,896,927	619,899	(133,070)

Notes to the Financial Statements

For the year ended 31 December 2018
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18 DERIVATIVE FINANCIAL INSTRUMENTS *(continued)*

Hedge accounting *(continued)*

(a) Fair value hedge

The following table shows the profit and loss effects of the fair value hedges:

	For the year ended 31 December 2017 (restated)
Net gains on hedging instruments	181,357
Net losses on hedged items attributable to the hedge risk	(188,350)
Net losses from fair value hedges	<u>(6,993)</u>

(b) Cash flow hedge

The Company uses foreign exchange forwards to hedge against exposures to cash flow variability primarily from foreign exchange risks of liabilities. The maturities of hedging instruments and hedged items are both within three years.

For the year ended 31 December 2017 (restated), the Company's net gain arising from cash flow hedge of HKD\$22,443,000 were recognized in other comprehensive income.

There were no transactions for which cash flow hedge accounting had to be ceased for the year ended 31 December 2017 (restated), as a result of the highly probable cash flows no longer being expected to occur.

19 LOANS AND ADVANCES TO CUSTOMERS

19.1 Loans and advances to customers

	As at 31 December 2018	As at 31 December 2017 (restated)
Loans and advances to customers	67,920,933	257,765,544
Less: ECL allowance	(232,214)	–
Less: Allowance for collectively assessed impairment losses	–	(1,109,849)
Less: Allowance for individually assessed impairment losses	–	(287,187)
	<u>67,688,719</u>	<u>256,368,508</u>

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

19 LOANS AND ADVANCES TO CUSTOMERS *(continued)*

19.2 Analysis of loans and advances to customers by collective and individual assessments

As at 31 December 2018	Stage 1 allowance	Stage 2 allowance	Stage 3 allowance	Total
Gross loans and advances	67,575,769	280,848	64,316	67,920,933
ECL allowance	(176,698)	(31,962)	(23,554)	(232,214)
Net loans and advances to customers	67,399,071	248,886	40,762	67,688,719

	Loans and advances for which the allowance is collectively assessed	For which the allowance is individually assessed	Total
As at 31 December 2017			
Gross loans and advances (restated)	257,208,642	556,902	257,765,544
Allowances for impairment losses (restated)	(1,109,849)	(287,187)	(1,397,036)
Net loans and advances to customers (restated)	256,098,793	269,715	256,368,508

19.3 Credit quality of loans and advances to customers

Loans and advances to customers analyzed by security type

	2018	2017 (restated)
Unsecured loans	17,105,433	125,095,630
Loan secured by guarantee	13,737,768	58,485,985
Collateralized and other secured loans	37,077,732	74,183,929
Gross amount of loans and advances to customers before impairment allowances	67,920,933	257,765,544

Notes to the Financial Statements

For the year ended 31 December 2018
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19 LOANS AND ADVANCES TO CUSTOMERS *(continued)*

19.4 Overdue loans

Gross advance to customers overdue for more than 3 months

	2018		2017 (restated)	
		% of gross advances to customers		% of gross advances to customers
Six months or less but over three months	3,392	0.00%	3,418	0.00%
One year or less but over six months	30,646	0.05%	54,720	0.02%
Over one year	15,320	0.02%	486,732	0.19%
Total gross amount of advances overdue for more than three months	49,358	0.07%	544,870	0.21%
ECL allowance for stage 3	20,996		N.A.	
Individual assessed impairment allowance made in respect of such advances	N.A.		276,629	

20 FINANCIAL INVESTMENTS

	2018	2017 (restated)
Debt securities at fair value through other comprehensive income		
– Listed	235,181	N.A.
– Unlisted	109,069,891	N.A.
Equity securities designated at fair value through other comprehensive income		
– Unlisted	9,990	N.A.
	109,315,062	N.A.

The Company has designated the investment in equity instrument issued by Joint Electronic Teller Services Limited at fair value through other comprehensive income. The Company chose this presentation alternative because the investment was made for strategic purposes rather than with a view to profit on a subsequent sale, and there is no plan to dispose this investment in short or medium term.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

20 FINANCIAL INVESTMENTS *(continued)*

The fair value of this investment is HK\$9,990,000 as at 31 December 2018 and a dividend of HK\$700,000 was recognized for the year. There is no transfer of the cumulative loss within equity.

	2018	2017 (restated)
Available-for-sale debt securities – at fair value		
– Listed in Hong Kong	N.A.	49,319,157
– Listed outside Hong Kong	N.A.	54,193,369
– Unlisted	N.A.	78,905,157
Debt securities	N.A.	182,417,683
Available-for-sale equity securities – at cost		
– Unlisted	N.A.	36,774
Total available-for-sale financial assets	N.A.	182,454,457
Held-to-maturity debt securities – at amortized cost		
– Listed outside Hong Kong	N.A.	3,895,864

(a) Financial investments analyzed by issuer are as follows:

	2018	2017 (restated)
Debt securities at fair value through other comprehensive income		
– Governments and central banks	14,914,288	N.A.
– Banks and other financial institutions	93,919,607	N.A.
– Corporate entities	471,177	N.A.
Equity securities at fair value through other comprehensive income		
– Banks and other financial institutions	9,990	N.A.
	109,315,062	N.A.

	2018	2017 (restated)
Available-for-sale financial assets		
– Governments and central banks	N.A.	11,734,301
– Public sector entities	N.A.	193,833
– Banks and other financial institutions	N.A.	150,015,526
– Corporate entities	N.A.	20,510,797
Total	N.A.	182,454,457
Held-to-maturity investments		
– Governments and central banks	N.A.	3,895,864

Notes to the Financial Statements

For the year ended 31 December 2018
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20 FINANCIAL INVESTMENTS *(continued)*

(b) The table below presents an analysis of debt securities by independent rating agencies designation as at 31 December 2018 and 2017:

	2018
	Financial investment – financial assets at fair value through other comprehensive income
HK\$ securities	
AAA	–
AA- to AA+	–
A- to A+	209,664
Below A-	–
Unrated (1)	10,139,050
Sub-total	10,348,714
Foreign currency securities	
AAA	93,960
AA- to AA+	18,013,676
A- to A+	16,533,557
Below A-	5,662,107
Unrated (1)	58,653,058
Sub-total	98,956,358
Total	109,305,072

Notes to the Financial Statements

For the year ended 31 December 2018
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20 FINANCIAL INVESTMENTS *(continued)*

(b) The table below presents an analysis of debt securities by independent rating agencies designation as at 31 December 2018 and 2017 *(continued)*:

	2017		Total (restated)
	Financial investments – available-for-sales (restated)	Financial investments – held-to maturity (restated)	
HK\$ securities			
AAA	–	–	–
AA- to AA+	947,551	–	947,551
A- to A+	1,796,951	–	1,796,951
Below A-	–	–	–
Unrated (1)	31,806,582	–	31,806,582
Sub-total	34,551,084	–	34,551,084
Foreign currency securities			
AAA	1,857,582	–	1,857,582
AA- to AA+	23,606,131	–	23,606,131
A- to A+	50,798,910	3,895,864	54,694,774
Below A-	27,242,370	–	27,242,370
Unrated (1)	44,361,606	–	44,361,606
Sub-total	147,866,599	3,895,864	151,762,463
Total	182,417,683	3,895,864	186,313,547

Note 1: These mainly represent investments and trading securities issued by “MOF”, “PBOC”, commercial banks and policy banks which are not rated by independent agencies.

Notes to the Financial Statements

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21 PROPERTY AND EQUIPMENT

	Buildings	Equipment	Transportation equipment	Property improvement	Total
Cost					
As at 1 January 2018	518,182	298,827	4,118	134,165	955,292
Additions	–	19,688	–	6,447	26,135
Disposal	–	(7,829)	–	(9,148)	(16,977)
Transfer of Excluded Business to HKBR (Note 2)	(518,182)	(248,794)	(4,118)	(48,047)	(819,141)
As at 31 December 2018	–	61,892	–	83,417	145,309
Accumulated depreciation					
As at 1 January 2018	(328,893)	(173,908)	(1,533)	(59,512)	(563,846)
Charge for the year	(961)	(14,116)	(104)	(17,945)	(33,126)
Disposal	–	5,654	–	9,140	14,794
Transfer of Excluded Business to HKBR (Note 2)	329,854	151,370	1,637	21,426	504,287
As at 31 December 2018	–	(31,000)	–	(46,891)	(77,891)
Net book value					
As at 31 December 2018	–	30,892	–	36,526	67,418

	Buildings (restated)	Equipment (restated)	Transportation equipment (restated)	Property improvement (restated)	Total (restated)
Cost					
As at 1 January 2017	518,182	262,279	5,781	119,871	906,113
Additions	–	43,959	1,818	29,961	75,738
Disposals	–	(7,411)	(3,481)	(15,667)	(26,559)
As at 31 December 2017	518,182	298,827	4,118	134,165	955,292
Accumulated depreciation					
As at 1 January 2017	(317,354)	(130,891)	(3,087)	(51,208)	(502,540)
Charge for the year	(11,539)	(50,428)	(1,927)	(23,971)	(87,865)
Disposals	–	7,411	3,481	15,667	26,559
As at 31 December 2017	(328,893)	(173,908)	(1,533)	(59,512)	(563,846)
Net book value					
As at 31 December 2017	189,289	124,919	2,585	74,653	391,446

Notes to the Financial Statements

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22 DEFERRED INCOME TAX ASSETS

The movements on the net deferred tax assets are as follows:

	2018	2017 (restated)
As at 1 January	11,352	130,855
Deferred income tax charged to income statement	39,271	25,213
Deferred income tax debited to equity	(8,901)	(144,716)
Transfer of Excluded Business to HKBR (Note 2)	(30,744)	–
As at 31 December	10,978	11,352

Deferred tax assets and liabilities are attributable to the following items:

	2018	2017 (restated)
Deferred tax assets		
Impairment allowances	37,701	183,125
Others	–	8,511
	37,701	191,636
Deferred tax liabilities		
Accelerated depreciation allowances	(9,896)	(2,782)
Revaluation of investment securities	(16,827)	(177,502)
	10,978	11,352

Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority. The deferred tax assets and liabilities are to be recovered and settled after one year and the following amounts, determined after appropriate offsetting, are shown in the statement of financial position:

	2018	2017 (restated)
Deferred tax assets	37,701	191,636
Deferred tax liabilities	(26,723)	(180,284)
	10,978	11,352

Notes to the Financial Statements

For the year ended 31 December 2018
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23 OTHER ASSETS

	2018	2017 (restated)
Interest receivable	755,467	2,865,486
Settlement accounts	685,639	1,334,495
Other receivables, prepayments and others	74,213	1,042,896
Less: Provision for impairment allowances on other receivables	N.A.	(45,955)
Less: ECL allowance	(13,840)	N.A.
Investment properties (a)	–	361,003
Intangible assets (b)	1,495	1,875
	1,502,974	5,559,800

(a) Investment properties

	2018	2017 (restated)
Balance at the beginning of the year (restated)	361,003	312,483
Gains on property revaluation (Note 9)	–	48,520
Transfer of Excluded business to HKBR (Note 2)	(361,003)	–
Balance at the end of the year	–	361,003

The Company's investment properties are located in active real estate markets. The external appraiser makes reasonable estimation of fair value using market prices of the similar properties.

As at 31 December 2017, fair value hierarchies of the investment properties of the Company were as follows:

	Level 1	Level 2	Level 3	Fair value as at 31 December 2017 (restated)
Commercial property units located in Hong Kong	–	–	361,003	361,003

The valuation of these investment properties located in Hong Kong as at 31 December 2017 were performed by RHL Appraisal Limited, an independent qualified professional valuer not connected to the Company. Valuation methodologies include "Rental Income Approach" and "Direct Comparison Approach". The inputs to these models mainly include growth rate of rental, capitalization rate and unit price.

Notes to the Financial Statements

For the year ended 31 December 2018
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23 OTHER ASSETS *(continued)*

(b) Intangible assets

	Software	Other right (Note)	Total
Cost			
As at 1 January 2017, 31 December 2017 (restated) and 1 January 2018	–	1,875	1,875
Additions	1,523	–	1,523
Transfer of Excluded business to HKBR (Note 2)	–	(1,875)	(1,875)
As at 31 December 2018	1,523	–	1,523
Accumulated depreciation			
As at 1 January 2017, 31 December 2017 (restated) and 1 January 2018	–	–	–
Amortization expenses	(28)	–	(28)
As at 31 December 2018	(28)	–	(28)
Net book value as at 31 December 2018	1,495	–	1,495
Net book value as at 31 December 2017 (restated)	–	1,875	1,875

Note: As at 31 December 2017, the Company holds the rights to connect its Automated Teller Machine (ATM) to the central data processing system of Joint Electronic Teller Services Limited (JETCO). This intangible assets are considered by the directors as having an indefinite useful life because the rights to use JETCO's central data processing system are expected to contribute to net cash inflow indefinitely. The intangible assets will not be amortized until their useful lives are determined to be finite. Instead, the intangible assets will be tested for impairment annually. For the purpose of impairment testing on the intangible assets held by the Company as at 31 December 2017, the recoverable amount have been determined based on the fair value less costs of disposal. For the year ended 31 December 2017, no impairment loss for intangible asset was recognized.

24 DUE TO BANKS AND OTHER FINANCIAL INSTITUTIONS

	2018	2017 (restated)
Deposits from banks and other financial institutions	18,876,951	2,210,433
Subordinated loan from the ultimate holding company	2,000,000	11,513,103
Financial assets sold under repurchase agreements (Note 33)	250,000	7,384,549
Total	21,126,951	21,108,085

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For the year ended 31 December 2018
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25 FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT OR LOSS

	2018	2017 (restated)
Derivative financial instruments (Note 18)	467,764	8,082,521
Short position of securities held for trading	–	2,972,678
Total	467,764	11,055,199

For the year ended 31 December 2018 and 2017, there were no significant changes in the fair value of the Company's financial liabilities designated as at fair value through profit or loss that were attributable to the changes in credit risk.

26 DUE TO CUSTOMERS

	2018	2017 (restated)
Demand deposits and current accounts	7,533,053	16,743,737
Saving deposits	50,960,428	88,130,005
Time, call, notice and other deposits	103,581,202	334,914,491
	162,074,683	439,788,233
Including:		
Deposits pledged as collateral	2,480,149	1,540,392

27 CERTIFICATES OF DEPOSIT ISSUED

	2018	2017 (restated)
Designated at fair value (Note)	–	13,836,549
At amortized cost	–	8,178,169
	–	22,014,718

Note: These certificates of deposit issued were designated as fair value through profit and loss upon initiation as the management considers such designation could eliminate or significantly reduce a measurement or recognition inconsistency that would otherwise result from measuring the corresponding financial assets or recognizing the gains or loss on them on different basis. Accordingly, these certificates of deposit issued are designated as fair value through profit and loss with changes in fair values charged to profit and loss account. For the year ended 31 December 2017, there were no significant changes due to the Company's changes in credit risks. For the year ended 31 December 2018, there is no change in fair value of the certificate of deposit issued designated at fair value arising from the changes in its credit risk.

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28 DEBT SECURITIES ISSUED

	2018	2017 (restated)
Designated at fair value (Note)	–	21,578,563
At amortized cost	–	17,310,104
	–	38,888,667

Note: These debt securities were designated as fair value through profit and loss upon initiation as the management considers such designation could eliminate or significantly reduce a measurement or recognition inconsistency that would otherwise result from measuring the corresponding financial assets or recognizing the gains or loss on them on different basis. Accordingly, the debts are designated as fair value through profit and loss with changes in fair values charged to profit and loss account. For the year ended 31 December 2018, there is no change in fair value of the debt securities issued designated at fair value arising from the changes in its credit risk. For the year ended 31 December 2017, there were no significant changes due to the Company's changes in credit risks.

29 OTHER LIABILITIES

	2018	2017 (restated)
Interest payable	840,072	2,527,171
Settlement accounts	3,462,534	1,384,587
Withholding tax	59,363	27,091
Provision for impairment allowances on financial guarantee and credit related commitment	10,941	–
Others	1,049,184	2,560,617
Total	5,422,094	6,499,466

30 SHARE CAPITAL

	Number of shares	Share capital
As at 31 December 2017 (restated) and 1 January 2018	300,000,000	300,000
As at 31 December 2018	17,900,000,000	17,900,000

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

31 FINANCIAL GUARANTEES AND CREDIT RELATED COMMITMENTS AND OTHER COMMITMENTS

Financial guarantees and credit related commitments

The following tables indicate the contractual amounts of the Company's financial guarantees and credit related commitments which the Company has committed to its customers:

	2018	2017 (restated)
Letters of guarantee	66,874	5,750,686
Letters of credit commitments	87,858	3,520,515
Acceptances bills	27,149	3,301,476
Credit card commitments	6,420,292	6,500,384
Other credit-related commitments		
– Under 1 year	2,796,298	6,352,755
– More than 1 year	2,723,227	17,002,128
	12,121,698	42,427,944

Capital expenditure commitments

	2018	2017 (restated)
Contracted but not provided for	16,095	1,340

Operating lease commitments

Where the Company is the lessee, the future minimum lease payments on certain property, plant and equipment under non-cancellable operating leases are as follows:

	2018	2017 (restated)
Within 1 year (inclusive)	–	246,760
Beyond 1 year but no more than 2 years (inclusive)	–	106,574
Beyond 2 years but no more than 3 years (inclusive)	–	32,004
	–	385,338

As at 31 December 2018, certain lease agreements have been signed by HKBR which the leases are used by the Company and the rental expenses are incurred by the Company. The Company does not have any commitment with respect to these operating lease agreements.

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

32 NOTES TO STATEMENT OF CASH FLOWS

Analysis of the balance of cash and cash equivalents

For the purposes of the statement of cash flows, cash and cash equivalents comprise the following balances with original maturities of less than or equal to 90 days used for the purpose of meeting short-term cash commitments:

	2018	2017 (restated)
Cash and balances with central bank (Note 15)	2,353,780	2,615,265
Due from banks and other financial institutions (Note 16)	9,351,210	37,976,496
	11,704,990	40,591,761

33 COLLATERALS

Financial assets sold under repurchase agreements included certain transactions under which, title of the pledged securities has been transferred to counterparties.

Sales and repurchase agreements are transactions in which the Company sells a security and simultaneously agrees to repurchase it (or an asset that is substantially the same) at a fixed price on a future date. Since the repurchase prices are fixed, the Company is still exposed to substantially all the credit risks and market risks and rewards of those securities sold. These securities, which the Company does not have the ability to use during the term of the arrangements, are not derecognized from the financial statements but regarded as "collateral" for the secured lending from these because the Company retains substantially all the risks and rewards of these securities. In addition, it recognizes a financial liability for cash received.

As at 31 December 2018 and 2017, the Company entered into repurchase agreements with certain counterparties. The proceeds from selling such securities were presented as "financial assets sold under repurchase agreements" (see Note 24).

	Transferred assets		Associated liabilities	
	2018	2017 (restated)	2018	2017 (restated)
Investment securities	250,842	7,715,369	(250,000)	(7,384,549)

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

34 RELATED PARTY TRANSACTIONS

(a) Parent entity

The Company is controlled by the following entity:

Name	Type	Place of incorporation	Ownership interest	
			2018	2017 (restated)
Bank of Communications Co., Ltd	Ultimate parent entity and controlling party	People's Republic of China	100%	100%

(b) Key management personnel compensation

	Ownership interest	
	2018	2017 (restated)
Short-term employee benefits	14,434	58,416
Post-employment benefits	1,248	3,142
	15,682	61,558

(c) Transactions with the MOF

As at 31 December 2018, the MOF holds 19,703 million (31 December 2017: 19,703 million) shares of the ultimate holding company of the Company which represents 26.53% (31 December 2017: 26.53%) of equity interest of the ultimate holding company of the Company.

The MOF is a Chinese government ministry, primarily responsible for managing state fiscal revenue and expenditures, and establishing and enforcing taxation policies. The Company enters into banking transactions with the MOF under normal course of business and they mainly include the purchase and redemption of financial investments issued by the MOF and the deposits from the MOF.

Details of transactions and outstanding balances are summarized below:

	Ownership interest	
	2018	2017 (restated)
Bonds issued by MOF	4,039,010	14,576,507
Other assets	20,939	164,342
Interest income	86,811	446,570

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

34 RELATED PARTY TRANSACTIONS *(continued)*

(d) Transactions with The Hong Kong and Shanghai Banking Corporation Limited and its subsidiaries (“HSBC”)

As at 31 December 2018, HSBC holds 13,886 million (31 December 2017: 13,886 million) shares of the ultimate holding company of the Company which represents 18.70% (31 December 2017: 18.70%) of total share capital of the Company. Transactions between the Company and HSBC are carried out under normal commercial terms and paid at market rates.

Details of transactions and outstanding balances are summarized below:

	2018	2017 (restated)
Due from banks and other financial institutions	3,664	88,012
Financial investments – financial assets at fair value through other comprehensive income	770,991	1,345,478
Derivative financial assets	564	1,311,450
Other assets	8,937	16,418
Due to banks and other financial institutions	11,860	234,448
Derivative financial liabilities	4,189	549,458
Interest income	15,220	41,541
Interest expense	990	20,242
Fee and commission expense	52	145

(e) Transactions with fellow subsidiaries

The pricing of the transactions with fellow subsidiaries is determined based on normal commercial banks.

Details of transactions and outstanding balances are summarized below:

	2018	2017 (restated)
Loans and advances to customers	438,541	4,873,643
Other assets	185	326,231
Due to banks and other financial institutions	96,243	67,971
Due to customers	281,498	1,411,201
Other liabilities	12,425	6,718
Derivative financial liabilities	–	2,864
Fee and commission income	1,657	55,582
Interest income	16,540	221,230
Interest expense	312	1,620
Fee and commission expense	12,048	15,235
Rental income	–	6,673
Rental expense	27,879	63,501
Other operating expenses	20,606	60,115

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

34 RELATED PARTY TRANSACTIONS *(continued)*

(f) Transactions with directors and senior management

	2018	2017 (restated)
Loans and advances to customers	811	1,481
Due to customers	39,720	51,743
Interest income	9	18
Interest expenses	672	683
Fee and commission income	79	158

Particular of loans made to directors of the Company pursuant to section 383 of the Hong Kong Companies Ordinance and Part 3 of the Companies (Disclosure of Information about Benefits of Directors) Regulation for the year ended 31 December 2018 and 2017 are as follows:

	2018	2017 (restated)
Aggregate amount of relevant transactions outstanding at year end	99	501
Maximum aggregate amount of relevant transactions outstanding during the year	468	698

(g) Transactions with the ultimate holding company

Transactions between the Company and the ultimate holding company are carried out under normal commercial terms and paid at market price.

Details of transactions and outstanding balances are summarized below:

	2018	2017 (restated)
Due from banks and other financial institutions	12,686,398	347,885
Other assets	5,565	84,934
Derivative financial assets	932,323	40,924
Due to banks and other financial institutions	20,167,573	18,872,051
Other liabilities	115,009	85,453
Derivative financial liabilities	411,154	113,020
Interest income	696,390	602,432
Interest expense	329,703	411,437
Other operating expenses	324,824	834
Other operating income	6,684	–
Purchase of loan and advances	29,501,670	–
Purchase of debt securities	115,281,247	–

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

35 SEGMENTAL ANALYSIS

The Company manages the business mainly from an operating segment perspective and the majority of the Company's revenues, profits before tax and assets are derived from Hong Kong. The Company is engaged predominantly in banking and related financial activities. It comprises corporate banking, personal banking, treasury and other business. Corporate banking mainly comprises corporate loans, bills, trade finance, corporate deposits and remittance. Personal banking mainly comprises individual loans, individual deposits, credit cards and remittance. Treasury mainly comprises money market placements and takings, financial investment, and securities sold under repurchase agreements. The "Others" segment mainly comprises unallocated revenue and expenses and corporate expenses.

The business information of the Company is summarized as follows:

	2018				Total
	Corporate Banking	Personal Banking	Treasury	Others	
External net interest income/(expense)	310,288	(1,112,676)	2,659,198	17	1,856,827
Inter-segment net interest income/(expense)	142,634	2,622,393	(2,765,017)	(10)	–
Net interest income/(expense)	452,922	1,509,717	(105,819)	7	1,856,827
Net fee and commission income/(expense)	109,624	630,242	(7,210)	–	732,656
Net gains arising from trading activities	1,198	23,771	341,853	–	366,822
Net losses arising from financial investments	–	–	(9,851)	–	(9,851)
Dividend income	–	–	700	–	700
Other operating income	132	15,957	2,513	2,380	20,982
Total operating income	563,876	2,179,687	222,186	2,387	2,968,136
Change in expected credit losses	(123,831)	10,754	(78,442)	(21,070)	(212,589)
Other operating expense					
– Depreciation and amortization	(1,635)	(27,443)	(221)	(3,855)	(33,154)
– Others	(96,768)	(930,353)	(69,893)	(373,604)	(1,470,618)
Profit/(loss) before tax	341,642	1,232,645	73,630	(396,142)	1,251,775
Income tax expense	–	–	–	(268,758)	(268,758)
Net profit/(loss) for the year	341,642	1,232,645	73,630	(664,900)	983,017
Depreciation and amortization	(1,635)	(27,443)	(221)	(3,855)	(33,154)
Capital expenditure	(265)	(18,620)	(636)	(6,614)	(26,135)
Segment assets	33,113,049	35,889,221	138,735,707	–	207,737,977
Unallocated assets	–	–	–	138,745	138,745
Total assets	33,113,049	35,889,221	138,735,707	138,745	207,876,722
Segment liabilities	(8,324,919)	(156,349,405)	(23,908,166)	–	(188,582,490)
Unallocated liabilities	–	–	–	(660,999)	(660,999)
Total liabilities	(8,324,919)	(156,349,405)	(23,908,166)	(660,999)	(189,243,489)

Notes to the Financial Statements

For the year ended 31 December 2018
(All amounts expressed in thousands of HK\$ unless otherwise stated)

35 SEGMENTAL ANALYSIS (continued)

	2017 (restated)				
	Corporate Banking	Personal Banking	Treasury	Others	Total
External net interest income/(expense)	1,974,155	(1,691,962)	4,777,964	30	5,060,187
Inter-segment net interest income/(expense)	282,294	2,979,580	(3,261,874)	–	–
Net interest income/(expense)	2,256,449	1,287,618	1,516,090	30	5,060,187
Net fee and commission income/(expense)	936,645	742,957	(20,298)	–	1,659,304
Net gains arising from trading activities	3,782	29,651	751,978	–	785,411
Net gains arising from financial investments	–	–	146,716	–	146,716
Dividend income	–	–	2,980	–	2,980
Other operating income	5,077	4,646	334	100,132	110,189
Total operating income	3,201,953	2,064,872	2,397,800	100,162	7,764,787
Change/(Reversal) in impairment allowance	(101,232)	(30,474)	31,160	(1,312)	(101,858)
Other operating expense					
– Depreciation and amortization	(9,625)	(28,908)	(1,133)	(48,199)	(87,865)
– Others	(578,084)	(1,284,635)	(381,234)	(99,897)	(2,343,850)
Profit/(loss) before tax	2,513,012	720,855	2,046,593	(49,246)	5,231,214
Income tax expense	–	–	–	(838,036)	(838,036)
Net profit/(loss) for the year	2,513,012	720,855	2,046,593	(887,282)	4,393,178
Depreciation and amortization	(9,625)	(28,908)	(1,133)	(48,199)	(87,865)
Capital expenditure	(3,202)	(27,510)	(17,904)	(27,122)	(75,738)
Segment assets	220,529,733	38,987,018	317,376,017	–	576,892,768
Unallocated assets	–	–	–	549,446	549,446
Total assets	220,529,733	38,987,018	317,376,017	549,446	577,442,214
Segment liabilities	(274,061,200)	(168,895,170)	(93,235,838)	–	(536,192,208)
Unallocated liabilities	–	–	–	(4,106,075)	(4,106,075)
Total liabilities	(274,061,200)	(168,895,170)	(93,235,838)	(4,106,075)	(540,298,283)

36 NON-ADJUSTING EVENT AFTER REPORTING PERIOD

The Company has no other significant subsequent events.

37 COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to current year presentation.

Unaudited Supplementary Financial Information

For the year ended 31 December 2018

The following information is disclosed as part of accompanying information to the financial statements and does not form part of the audited financial statements.

1 Corporate Governance

Sound corporate governance is the system guarantee for sustainable development and the key for prudent operation of a commercial bank. The Company was committed to fulfill the responsibilities of corporate governance and continuously moved forward the establishment of the corporate governance policy and mechanism. The Company was also refined the assignment of duties and authorities of Specialized Committees under the Board of Directors which continuously enhance the effectiveness of corporate governance.

The Company has complied with, in material respects, the requirements set out in the Supervisory Policy Manual Module, CG-1 "Corporate Governance of Locally Incorporated Authorised Institutions" issued by the Hong Kong Monetary Authority ("HKMA").

The Company has established a corporate governance structure comprising the Sole Shareholder, the Board of Directors, the Specialized Committees, Management-level Committee and Senior Management, with clearly defined authorities and responsibilities, balanced equilibrium, and coordinated and independent operation.

The Board has set up four Specialized Committees, namely Audit Committee, Nomination Committee, Remuneration Committee and Risk Management Committee since June 2017, which are delegated with different responsibilities to assist the Board in performing its duties.

2 Board of Directors

The Board is at the core of the Company's corporate governance framework and has the ultimate responsibilities to the shareholder, depositors, creditors, employees and other stakeholders, banking supervisors of the Company. In discharging its responsibilities, the Board strives to establish sound risk management and internal control systems for ensuring the business and operations are managed in a prudent, professional and competent manner and in conformity with relevant laws and regulations.

Generally, the key responsibilities of the Board are as follows:

- (1) To formulate the objectives and strategies as well as monitoring the implementation thereof;
- (2) To review and monitor the risk management and internal control system;
- (3) To appoint senior management and monitor its performance;
- (4) To set corporate values and standards to promote ethical and responsible professional behavior amongst staff;
- (5) To oversee and monitor Senior Management's implementation of remuneration system; and
- (6) To review and approve the annual business plans and financial budgets.

Unaudited Supplementary Financial Information

For the year ended 31 December 2018

2 Board of Directors *(continued)*

During the year, the Board had held six (6) meetings and major works performed by the Board include:

- (1) Approval of annual financial budget and financial accounts;
- (2) Approval of the issuance of 17.6 billion ordinary shares and acceptance of the HK\$2 billion subordinated shareholder loan;
- (3) Approval of appointments of two Non-executive Directors, including an additional Non-executive Director;
- (4) Approval of the proposed appointment of Independent Non-executive Director to fill up the casual vacancy. According to the Banking Ordinance, consent of accepting the proposed appointment from HKMA is required. As at the date of this report, the application of consent from HKMA is still in progress;
- (5) Review and approval of the risk appetite, the recovery plan, report of Internal Capital Adequacy Assessment Process (“ICAAP”) as well as various risk management and capital management policies;
- (6) Review of the work carried out by Specialized Committees; and
- (7) Review of the annual statement of business continuity plan and the business continuity drill report.

3 Audit Committee

The Audit Committee, established and authorized by the Board, is primarily responsible for monitoring the effectiveness of the Company’s Internal Audit function and work performed by external auditors. The main duties of the Audit Committee are as follows:

- (1) To draw up, review and update periodically the Terms of Reference of the Audit Committee for the Board’s approval;
- (2) To establish the responsibility and independence of the Internal Audit function, and to provide guidance to the Audit Department of the Company (the “Audit Department”);
- (3) To approve the Audit Charter drawn up and updated periodically by the Audit Department;
- (4) To approve the annual Audit Plan and the related manpower and financial resources required after identifying the areas of risk within the Company’s operations to be covered;
- (5) To assess all major aspects of the Internal Audit function periodically, and to make suggestions for improvement on its effectiveness;
- (6) To receive audit reports and review significant recommendations and implementation plans and furthermore, to ensure that the Senior Management has taken timely remedial actions as necessary to tackle the internal control weaknesses, the areas of non-compliance with the laws, regulations and policies and issues identified by external auditors;
- (7) To review ad-hoc non-compliance incident reports and HKMA on-site examination reports, etc.;
- (8) To recommend to the Board with regard to the appointment, remuneration and termination of external auditors, to consider their audit work plans, and to review their audit conclusions and significant recommendations;
- (9) To review accounting policies, financial conditions and financial reporting process; and
- (10) To provide opportunities for external and internal auditors to meet and discuss their respective findings.

Unaudited Supplementary Financial Information

For the year ended 31 December 2018

3 Audit Committee *(continued)*

According to the Terms of Reference of the Audit Committee, all Audit Committee members should be Non-executive Directors appointed by the Board. Besides, the majority of whom (including the Chairman) should be Independent Non-executive Directors. All current members of the Audit Committee are Independent Non-executive Directors; namely Mr. Tang Kwai Chang (Chairman of the Audit Committee) and Mr. Chan Ka Lok. Mrs. Lam Cheung Alexa (former Audit Committee member) ("Mrs. Lam") resigned as Audit Committee member on 30 September 2018. The vacancy will be filled up by an Independent Non-executive Director as soon as his/her appointment is officially approved by the Board.

During the year, the Audit Committee had held four (4) meetings.

4 Nomination Committee

The main duties of the Nomination Committee are as follows:

- (1) To identify individuals suitably qualified to become members of the Board or of Senior Management, and to select, or to make recommendations to the Board on the selection of, individuals nominated for directorships and Senior Management positions; and to ensure objectivity and independence in the selection process for Board members and Senior Management;
- (2) To make recommendations to the Board on the appointment or re-appointment of Directors and succession planning for Directors;
- (3) To review the independence of the Independent Non-executive Directors;
- (4) To undertake regular assessments of the Board performance to assist the Board in reviewing the efficiency and effectiveness of the functioning of the Board; and
- (5) To undertake regular assessments of the ongoing suitability of each Board member.

Basically, the Nomination Committee comprises the Chairman of the Board and at least two Independent Non-executive Directors.

Currently, the Nomination Committee consists of the Chairman of the Board and an Independent Non-executive Director; namely Mr. Wang Feng (Chairman of the Nomination Committee) and Mr. Chan Ka Lok respectively. Mrs. Lam resigned as the member of the Nomination Committee on 30 September 2018. The vacancy will be filled up by an Independent Non-executive Director as soon as his/her appointment is officially approved by the Board. (Mr. Shou Fugang resigned as the Chairman of the Nomination Committee on 27 February 2019, and Mr. Wang Feng was appointed as the Chairman of the Nomination Committee on the same day.)

Six (6) Nomination Committee meetings were held during the year. Major works performed during the year include:

- (1) Consideration of the matters relating to the adjustment and appointment of Directors and Senior Management;
- (2) Review of the Terms of Reference of the Nomination Committee;
- (3) Consideration and review of policies related to the succession and appointment of Directors and Senior Management;
- (4) Review of policies related to the management of organizational structure; and
- (5) Evaluation of the performance of the Board and its Specialized Committees.

Unaudited Supplementary Financial Information

For the year ended 31 December 2018

5 Remuneration Committee

The main duties of the Remuneration Committee are as follows:

- (1) To make recommendations to the Board on the Company's remuneration policy and structure for all Directors, Chief Executive (including Alternate Chief Executives), Senior Management and Key Personnel and on the establishment of a formal and transparent procedure for developing a remuneration policy;
- (2) To make recommendations to the Board on the remuneration by reference to corporate goals and objectives resolved by the Board, and on the remuneration packages of Directors, Chief Executive and Senior Management;
- (3) To make recommendations in respect of remuneration policy and practices to the Board, and to ensure that the remuneration policy is consistent with the principles set out in the Supervisory Policy Manual Module, CG-5 "Guideline on a Sound Remuneration System" of HKMA and any other legal or regulatory requirements;
- (4) To develop and promote a sound bank culture according to the "Bank Culture Reform" guidance issued by HKMA, to support prudent risk management and to contribute towards promoting proper staff behavior leading to positive customer outcomes and high ethical standards in the banking industry;
- (5) To exercise competent and independent judgement on remuneration policies and practices, as well as the incentives thereby created for managing risk, capital and liquidity; to work closely with other relevant Board Committees and consulting compliance function in the evaluation of the incentives created by the remuneration system; and
- (6) To ensure that a regular review of the Company's remuneration system and its operation, either internally conducted or externally commissioned, is carried out independently of management and the result is submitted to the HKMA.

The Remuneration Committee comprises at least three members. The Committee shall be chaired by an Independent Non-executive Director, and the majority of members shall be Independent Non-executive Directors. Current members of the Remuneration Committee are Mr. Chan Ka Lok (Chairman of the Remuneration Committee), Mr. Tang Kwai Chang and Ms. Zhu Chen.

Five (5) Remuneration Committee meetings were held during the year. Major works performed during the year include:

- (1) Formulation, review and amendment to remuneration policies;
- (2) Review of the Terms of Reference of the Remuneration Committee;
- (3) Consideration of the proposal on staff bonus for year 2017 and of the proposal on salary adjustment for year 2018;
- (4) Consideration of remuneration relating to the adjustment and appointment of Directors;
- (5) Listening to the report of the annual audit review on remuneration policies; and
- (6) Listening to the implementation report of the bank culture reform.

Unaudited Supplementary Financial Information

For the year ended 31 December 2018

6 Risk Management Committee

The main duties of the Risk Management Committee are as follows:

- (1) To establish the risk appetite and the strategy in risk management, judge the risk level in each kind of risk;
- (2) To identify, assess, and manage different kind of risk faced by the Company;
- (3) To review and access the risk management process of the Company, and the adequacy of system and internal control;
- (4) To review and monitor the compliance of risk management policies, procedures, system and internal control; and
- (5) To conduct annual review on the ICAAP procedure and report to ensure the Company has adequate capital to cater for major risk by assessing the business and risk strategy.

Basically, the Risk Management Committee is composed of one Executive Director and two Independent Non-executive Directors. Four (4) meetings were held in the year of 2018. During the year, the major tasks completed by the Risk Management Committee included the following:

- (1) Review and provision of recommendations on risk management strategy, and risk level/appetite that could be acceptable by the Company for Board's approval;
- (2) Review and evaluation of the risk management structure and policies on whether they are able to identify, measure, monitor and control the risk faced by the Company and regular review on the risk management structure and policies to ensure they can function effectively;
- (3) Review of the reports from the Comprehensive Risk Committee about the risk exposures and risk management activities;
- (4) Review and approval of high level risk policies and measures;
- (5) Approval of various risk management limits; and
- (6) Review and provision of recommendation on the Recovery Plan for Board's approval.

Currently, the Risk Management Committee consists of an executive Director and an Independent Non-executive Director; namely Mr. Cheng Man Wang and Mr. Tang Kwai Chang respectively. Mrs. Lam resigned as the Chairman of the Risk Management Committee on 30 September 2018. The vacancy will be filled up by an Independent Non-executive Director as soon as his/her appointment is officially approved by the Board.