



BANK OF COMMUNICATIONS (HONG KONG) LIMITED

(Incorporated in Hong Kong with limited liability)

2020 ANNUAL REPORT



Bank of Communications (Hong Kong) Limited

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Report of the Directors

The board of directors of Bank of Communications (Hong Kong) Limited (the “Bank”) hereby submit their report with the audited financial statements for the year ended 31 December 2020.

Principal activity

The principal activity of the Bank is provision of banking services in Hong Kong.

Results and appropriations

The results of the Bank for the year are set out in the statement of profit or loss and other comprehensive income on page 10.

The board of directors do not recommend the payment of a dividend in respect of the year ended 31 December 2020.

Business Review

No business review was presented for the year ended 31 December 2020 as the Bank had 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 (incorporated in People’s Republic of China).

Donations

There were no charitable and other donations made by the Bank during the years ended 31 December 2020 and 2019.

Share issued in the year

Details of the share issued in the year ended 2020 are set out in Note 29 to the financial statements.

Directors of the Bank

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

Chairman:

Wang Feng

Executive directors:

Chan Ha Fong, Nancy

Meng Yu (resigned on 26 November 2020)

Fan Chaorong

Non-executive directors:

Zhang Hui (resigned on 26 November 2020)

Zhu Chen

Independent non-executive directors:

Chan Ka Lok

Tang Kwai Chang

Chan Ching Har Eliza

Lam Yim Nam

Meng Yu resigned on 26 November 2020 as executive director of the Bank and Zhang Hui resigned on 26 November 2020 as non-executive director of the Bank. Meng Yu and Zhang Hui had confirmed that they had no disagreement with the Board and nothing relating to the affairs of the Bank needed to be brought to the attention of the shareholders of the Bank.

In accordance with the Bank’s Articles of Association, the existing directors shall remain in the office.

Report of the Directors

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

No transactions, arrangements and contracts of significance in relation to the Bank's business to which the Bank's fellow subsidiaries or its holding company was a party and in which a director of the Bank 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 Bank or any specified undertaking of the Bank

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

Non-adjusting event after reporting period

Non-adjusting events which have occurred after 31 December 2020 are disclosed in note 36 to the notes to financial statements.

Management contracts

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

Permitted indemnity provisions

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

Auditor

The financial statements for the year ended 31 December 2020 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, 1 April 2021

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 "Bank") set out on pages 10 to 103, which comprise:

- the statement of financial position as at 31 December 2020;
- 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 Bank as at 31 December 2020, 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 ("HKSA") 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 Bank 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

Key Audit Matters

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

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

- Impairment of loans and advances to customers
- Purchase of loans and advances to customers

Key Audit Matter

Impairment of loans and advances to customers

As at 31 December 2020, the Bank reported total gross loans and advances to customers of HK\$138,089m and HK\$574m of total expected credit loss ("ECL") allowance, comprising HK\$381m, HK\$149m and HK\$44m in Stages 1, 2 and 3 respectively. Refer to notes 3.1 and 19 to the Bank's financial statements.

ECL of the Bank is determined through management's assessment of the changes in credit quality of loans and advances to customers since their initial recognition through a three-stage impairment model. For loans and advances to customers classified into Stage 1 and Stage 2, a risk parameter modelling approach is taken, incorporating key management judgements such as management's macro-economic forecasts ("MEF"), determination of significant increase in credit risk ("SICR") and internal credit ratings. For loans and advances to customers in Stage 3, the loan loss allowance is determined by management through estimating the future cash flows from the credit-impaired loans and advances to customers.

How our audit addressed the Key Audit Matter

We tested the key controls that management have established to support their calculation of ECL, including:

- Governance process over ECL models, including applicability of the modelling methodology and appropriateness of significant management judgements applied over the SICR, internal credit ratings, MEF and, for ECL on Stage 3 loans and advances to customers, the estimated recoverable amounts based on future cashflows;
- Analysis over reasonableness of ECL results;
- Controls over key data inputs to source system, user access management, and interface between the source systems and the ECL models; and
- Regular and additional thematic post draw-down monitoring controls to challenge the appropriateness of the credit quality grading, particularly on the customers or loan portfolios that were impacted by the pandemic.

With the support of our internal credit modelling specialist, we evaluated the appropriateness of the modelling methodology, giving the specific considerations to the impact of COVID-19.

Independent Auditor's Report

Key Audit Matters *(continued)*

Key Audit Matter

The macro-economic environment was volatile in 2020 with the onset of the Covid-19 pandemic and geopolitical developments, adding challenges to the inherently complex ECL determination, primarily due to the greater estimation uncertainty surrounding the forward-looking economic information and assessment of credit risk in the Bank's loan portfolios under the lingering impact of the pandemic.

The applicability of the existing ECL modelling methodology and appropriateness of management's assumptions require re-assessment as part of the Bank's governance process and particularly essential under the pandemic situation.

Determination of the abovementioned MEF, SICR, internal credit ratings and assessment of the appropriateness of the ECL modelling methodology required significant management judgements and therefore we determined this area to be a key audit matter.

How our audit addressed the Key Audit Matter

We independently assessed the reasonableness of the MEF scenarios and management's judgements in determining the probability weighting of each scenario applied by comparing them to external economic forecasts and other available public information, taking into consideration the latest developments of COVID-19 and the geopolitical situation.

Our audit procedures also included assessing the reasonableness of the SICR determination applied in classifying loans between Stage 1 and Stage 2 as well as assessing the reasonableness of the internal credit ratings for a sample of loans with a focus of our testing on the higher risk industries hard hit by COVID-19, which in turn drives the determination of the probability of default in the ECL calculation. Our assessment considered the financial and non-financial information of the borrowers, along with external information available, including adjusting events occurring after the year end of 31 December 2020, if any.

Based on the audit procedures performed, we considered the key judgements adopted by management in the impairment assessment of loans and advances to customers are supportable by available evidence.

Independent Auditor's Report

Key Audit Matters *(continued)*

Key Audit Matter

Purchase of loans and advances to customers

For the year ended 31 December 2020, the Bank purchased total gross loans and advances to customers of HK\$63b from the Hong Kong branch of its ultimate holding company, Bank of Communications Co. Ltd.. Refer to note 34(g) to the Bank's financial statements.

The Bank's purchase of loans and advances of customers from its ultimate holding company was under normal commercial terms, and measured and recorded at the fair value of the loans and advances to customers at the date of the purchase. The methodology applied in determination of fair value was through re-computation of the discounted cash flows of the individual loans and advances. Management judgement is required in the determination of fair value such as the calculation of the discount rate (or credit spread), which is impacted by the credit quality of the loans and advances to customers and the probability of the embedded options of the loans and advances to customers being exercised.

We determined this area to be a key audit matter due to the magnitude of the amount involved, along with significant management judgements required in the determination of the fair value of the loans and advances purchased.

How our audit addressed the Key Audit Matter

We performed a number of audit procedures over the purchase of these loans and advances to customers, in particular:

- We assessed the appropriateness of the methodology applied by the Bank in determining the fair value of the purchased loans and advances to customers, with the support of our internal valuation specialist; and
- We selected samples, and involved our internal valuation specialist to evaluate key judgements made by management and checked the mathematical accuracy of management's computation of the discounted cashflow balance. These key judgements include the assessment of whether there has been a material change in the credit quality of the loans and advances to customers since loan origination, changes in credit spread and probability of exercising any embedded options in the loans and advances to customers.

Based on the audit procedures performed, we found the management judgements applied in the fair value determination of the purchased loans and advances to customers to be reasonable.

Independent Auditor's Report

Other Information

The directors are responsible for the other information. The other information comprises all of the information included in the annual report other than 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 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 Bank'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 Bank or to cease operations, or have no realistic alternative but to do so.

The Audit Committee is responsible for overseeing the Bank'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 Bank'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 Bank'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 Bank 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.

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

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

The engagement partner on the audit resulting in this independent auditor's report is Tam Man Kit, James.

PricewaterhouseCoopers
Certified Public Accountants

Hong Kong, 1 April 2021

Statement of Profit or Loss and Other Comprehensive Income

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

	Notes	Year ended 31 December	
		2020	2019
Interest income		5,324,947	6,076,016
Interest expense		(3,046,807)	(3,154,847)
Net interest income	4	2,278,140	2,921,169
Fee and commission income	5	814,846	746,623
Fee and commission expense	6	(56,634)	(56,536)
Net fee and commission income		758,212	690,087
Net gains arising from trading activities	8	544,990	76,413
Net gains arising from financial investments		165,906	425,804
Dividend income	7	35	35
Other operating income	9	15,080	21,541
Change in expected credit losses	10	(470,324)	(159,988)
Other operating expenses	11	(1,544,103)	(1,546,227)
Profit before tax		1,747,936	2,428,834
Income tax expenses	14	(297,567)	(366,160)
Net profit for the year		1,450,369	2,062,674
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>		(268)	(25)
<i>Items that may be reclassified to profit or loss:</i>			
<i>Debt investments at fair value through other comprehensive income</i>			
<i>Net gains recorded in equity</i>		920,285	890,277
<i>Net gains reclassified from equity to profit or loss</i>		(138,532)	(496,062)
Other comprehensive income for the year		781,485	394,190
Total comprehensive income for the year		2,231,854	2,456,864

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	
		2020	2019
	<i>Notes</i>		
ASSETS			
Cash and balances with central bank	15	8,438,950	1,094,956
Due from banks and other financial institutions	16	20,094,736	17,667,908
Financial assets at fair value through profit or loss	17	905,433	1,064,926
Financial assets at fair value through other comprehensive income	20	201,947,823	122,242,273
Loans and advances to customers	19	137,514,670	79,201,615
Property and equipment	21	55,792	53,476
Current tax assets		50,290	–
Right-of-use assets	23	234,130	298,409
Other assets	24	3,722,018	5,489,437
Total assets		372,963,842	227,113,000
LIABILITIES			
Due to banks and other financial institutions	25	71,659,676	28,736,570
Due to customers	26	245,749,909	170,755,289
Financial liabilities at fair value through profit or loss	27	2,783,985	1,168,798
Current tax liabilities		–	534,932
Deferred income tax liabilities	22	163,500	46,906
Lease liabilities	23	238,333	301,488
Other liabilities	28	5,251,296	4,483,009
Total liabilities		325,846,699	206,026,992
EQUITY			
Share capital	29	37,900,000	17,900,000
Additional equity instrument	30	3,871,450	–
Other reserves		1,262,649	481,164
Retained earnings		4,083,044	2,704,844
Total equity		47,117,143	21,086,008
Total equity and liabilities		372,963,842	227,113,000

The financial statements were approved and authorized for issuance by the Board of Directors on 1 April 2021 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)

	Notes	Attributable to the shareholder of the Bank				Total
		Share capital	Additional equity instrument	Other reserve	Retained earnings (Note (a))	
At 1 January 2020		17,900,000	–	481,164	2,704,844	21,086,008
Net profit for the year		–	–	–	1,450,369	1,450,369
Other comprehensive income		–	–	781,485	–	781,485
		17,900,000	–	1,262,649	4,155,213	23,317,862
Issuance of additional equity instrument	30	–	3,871,450	–	–	3,871,450
Issuance of share capital	29	20,000,000	–	–	–	20,000,000
Dividends paid to additional equity instrument holders	30	–	–	–	(72,169)	(72,169)
At 31 December 2020		37,900,000	3,871,450	1,262,649	4,083,044	47,117,143
At 1 January 2019		17,900,000	–	86,974	646,259	18,633,233
Change in accounting policy		–	–	–	(4,089)	(4,089)
Restated balance at 1 January 2019		17,900,000	–	86,974	642,170	18,629,144
Net profit for the year		–	–	–	2,062,674	2,062,674
Other comprehensive income		–	–	394,190	–	394,190
At 31 December 2019		17,900,000	–	481,164	2,704,844	21,086,008

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 Bank subject to consultation with the HKMA. As at 31 December 2020, HK\$749,460,000 (2019: HK\$891,005,000) 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	
	2020	2019
	<i>Notes</i>	
Cash flows from operating activities:		
Profit before tax	1,747,936	2,428,834
Adjustments for:		
Change in expected credit losses	470,324	159,988
Depreciation and amortization	24,420	30,365
Depreciation of right-of-use assets	177,833	166,890
Finance costs – lease interest expense	4,699	4,820
Loss on disposal of property and equipment	–	25
Interest income from financial investments	(2,868,572)	(3,531,136)
Fair value losses/(gains)	20,389	(38,828)
Dividend income	(35)	(35)
Withholding tax	144	–
Net gains arising from financial investments	(165,906)	(425,804)
Operating cash flows before movements in operating assets and liabilities	(588,768)	(1,204,881)
Net decrease in due from banks and other financial institutions	8,405,462	3,000,205
Net decrease in financial assets at fair value through profit or loss	139,104	829,256
Net increase in loans and advances to customers	(58,574,633)	(11,605,133)
Net decrease/(increase) in other assets	2,373,629	(3,966,740)
Net increase in due to banks and other financial institutions	42,923,106	7,609,619
Net increase in financial liabilities at fair value through profit or loss	1,615,187	701,034
Net increase in due to customers	74,994,620	8,680,606
Net increase/(decrease) in other liabilities	759,045	(942,931)
Income tax paid	(923,998)	–
Net cash inflows from operating activities	71,122,754	3,101,035

Statement of Cash Flows

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

	Year ended 31 December	
	2020	2019
	<i>Notes</i>	
Cash flows from investing activities:		
Purchase of financial investments	(180,324,800)	(155,694,231)
Disposal or redemption of financial investments	101,526,815	143,601,346
Dividend received	35	35
Interest received from financial investments	2,267,302	3,520,322
Purchase of property and equipment	(23,479)	(15,037)
Purchase of intangible assets	(10,379)	(12,114)
Net cash outflows from investing activities	(76,564,506)	(8,599,679)
Cash flows from financing activities:		
Principal elements of lease payments	(176,709)	(166,931)
Interest paid for lease	(4,699)	(4,820)
Proceeds from issuance of share capital	20,000,000	–
Issuance of additional equity instrument	3,890,605	–
Cost paid for issuance for additional equity instrument	(19,155)	–
Dividend paid to additional equity instrument holders	(72,169)	–
Net cash inflows/(outflows) from financing activities	23,617,873	(171,751)
Net increase/(decrease) in cash and cash equivalents	18,176,121	(5,670,395)
Cash and cash equivalents at the beginning of the year	6,034,595	11,704,990
Cash and cash equivalents at the end of the year	24,210,716	6,034,595
	32	
Net cash flows from operating activities include:		
Interest received	2,269,520	2,471,431
Interest paid	(3,333,866)	(3,267,520)

The accompanying notes form a part of these financial statements.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

1 GENERAL

Bank of Communications (Hong Kong) Limited (“the Bank”) is a company incorporated and domiciled in Hong Kong.

On 29 September 2015, the Hong Kong Monetary Authority granted the Bank 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 Bank in accordance with section 4 (1) of the Ordinance. Accordingly, the Bank commenced its retail banking business and private banking business on the Appointed Day.

On 6 January 2020, the Bank has altered its articles of association and the Bank’s status has been changed from a private company to a public company with effect from 6 January 2020.

In March 2020, the Bank issued USD500 million undated non-cumulative subordinated Additional Tier 1 capital securities.

In September 2020, the Bank issued HKD20 billion share capital to Bank of Communications Co. Ltd.

The address of its registered office is 20 Pedder Street, Central, Hong Kong and principal place of business is Unit B B/F & G/F, Unit C G/F, 1-3/F, 16/F Rm01 & 18/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.

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

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 which are measured at fair value.

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

Notes to the Financial Statements

For the year ended 31 December 2020
(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 applied by the Bank

Amendments to HKAS 1 and HKAS 8 (effective by 1 January 2020)	Definition of Material
Amendments to HKFRS 3 (effective by 1 January 2020)	Definition of a Business
Amendments to HKFRS 16 (effective by 1 June 2020)	Covid-19-Related Rent Concessions
Amendments to HKFRS 9, HKAS 39 and HKFRS 7 (effective by 1 January 2020)	Interest Rate Benchmark Reform

Interest Rate Benchmark Reform

The amendments to HKFRS 9, HKAS 39 and HKFRS 7 provide targeted relief for financial instruments qualifying for hedge accounting in the lead up to Interest Rate Benchmark Reform. Key changes include:

- modifying specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark on which the hedged cash flows and cash flows from the hedging instrument are based will not be altered as a result of interest rate benchmark reform;
- mandatory for all hedging relationships that are directly affected by the interest rate benchmark reform;
- are not intended to provide relief from any other consequences arising from interest rate benchmark reform (if a hedging relationship no longer meets the requirements for hedge accounting for reasons other than those specified by the amendments, discontinuation of hedge accounting is required); and
- requiring specific disclosures about the extent to which the entities' hedging relationships are affected by the amendments.

The Bank has established a project to manage the transition for any of its contracts that could be affected. The project is coordinated by Deputy Chief Executive and involved senior representatives from functions across the Bank including the asset and liability management, front line business and product management, legal and compliance, finance, risk management, operations and technology. The project team provides progress updates to the project steering committee and the senior management at least on a monthly basis.

The Bank applies hedge accounting on hedging its interest rate risk on certain debt investments, loans and advances to customers and therefore is exposed to changes in fair value due to movements in market rates. The Bank's derivatives instruments designated in hedge accounting relationships have floating legs that are indexed to with HIBOR or USD LIBOR. The Bank has fair value hedge accounting relationships mature beyond the anticipated cessation date for USD LIBOR. The Bank expects that USD LIBOR will be discontinued after the end of 2021. Secured Overnight Financing Rate ("SOFR") is recommended as the alternative reference rate.

Notes to the Financial Statements

For the year ended 31 December 2020
(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 applied by the Bank (continued)

Interest Rate Benchmark Reform (continued)

Significant judgement will be required in determining when uncertainty is expected to be resolved and when the targeted relief will cease to apply. As at 31 December 2020, the Bank believes uncertainty continues to exist as to when and how the replacement may occur with respect to the relevant derivative hedging instruments and so the targeted reliefs applied to the Bank's hedge accounting relationships that reference benchmarks subject to reform or replacement.

As at 31 December 2020, the derivative instruments designated in fair value hedge accounting relationships were linked to interbank offered rate reference rates and directly affected by the amendments:

As at 31 December 2020	Notional amount
Fair value hedge	
Interest rate contract	
USD London Interbank Offered Rate	83,530,304

The notional amount of derivative hedging instruments provides a close approximation to the extent of the risk exposure the Bank manages through hedging relationships that is directly affected by the reform and impacted by the amendments. The notional contract amounts of interest rate derivatives designated in qualifying hedge accounting relationships indicate the nominal value of transactions outstanding as at the reporting date, they do not represent amounts at risk. The Bank has initially adopted the new amendments to HKFRS 9, HKAS 39 and HKFRS 7 from 1 January 2020 and concluded it does not have a material impact on the Bank's operating results, financial position or other comprehensive income.

The other amendments listed above did not have any impact on the amounts recognized in prior periods and are not expected to significantly affect the current or future periods.

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

Certain new accounting standards and interpretations have been published that are not mandatory for 31 December 2020 reporting periods and have not been early adopted by the Bank. These standards are not expected to have a material impact on the entity in the current or future reporting periods and on foreseeable future transactions.

Annual Improvements to HKFRS Standards 2018-2020 (effective for annual period beginning on or after 1 January 2022)

The Annual Improvements to HKFRSs 2018-2020 Cycle include a number of amendments to various HKFRSs:

- HKFRS 9 Financial Instruments – clarifies which fees should be included in the 10% test for derecognition of financial liabilities.
- HKFRS 16 Leases – amendment of illustrative example 13 to remove the illustration of payments from the lessor relating to leasehold improvements, to remove any confusion about the treatment of lease incentives.

Amendments to HKFRS 9, HKAS 39, HKFRS 7, HKFRS 4 and HKFRS 16 (effective for annual period beginning on or after 1 January 2021)

Amendments to HKFRS 9, HKAS 39, HKFRS 7, HKFRS 4 and HKFRS 16 address issues not dealt with in the previous amendments which affect financial reporting when an existing interest rate benchmark is replaced with an alternative risk-free-rate ("RFR"). The Phase 2 amendments provide a practical expedient to allow the effective interest rate to be updated without adjusting the carrying amount when accounting for changes in the basis for determining the contractual cash flows of financial assets and liabilities, if the change is a direct consequence of the interest rate benchmark reform and the new basis for determining the contractual cash flows is economically equivalent to the previous basis immediately preceding the change.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.1 Basis of preparation *(continued)*

2.1.2 Standards and amendments that are not yet effective and have not been adopted by the Bank *(continued)*

In addition, the amendments permit changes required by the interest rate benchmark reform to be made to hedge designations and hedge documentation without the hedging relationship being discontinued. Any gains or losses that could arise on transition are dealt with through the normal requirements of HKFRS 9 to measure and recognize hedge ineffectiveness. The amendments also provide a temporary relief to entities from having to meet the separately identifiable requirement when an RFR is designated as a risk component. The relief allows an entity, upon designation of the hedge, to assume that the separately identifiable requirement is met, provided the entity reasonably expects the RFR risk component to become separately identifiable within the next 24 months.

Furthermore, the amendments require an entity to disclose additional information to enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy. The amendments are effective for annual periods beginning on or after 1 January 2021 and shall be applied retrospectively, but entities are not required to restate the comparative information.

The Bank held interest-bearing financial instruments denominated in Hong Kong dollars and foreign currencies based on various Interbank Offered Rates as at 31 December 2020. If the interest rates of these financial instruments are replaced by RFRs in a future period, the Bank will apply this practical expedient upon the modification of these financial instruments when the "economically equivalent" criterion is met. Moreover, the Bank currently has applied hedge accounting on hedging its interest rate risk on certain debt investments, loans and advances to customers and therefore is exposed to changes in fair value due to movements in market rates. The Bank's derivatives instruments designated in hedge accounting relationships have floating legs that are indexed to with HIBOR or USD LIBOR. The Bank will amend the formal designation of its hedge accounting relationships upon modification of the derivative instruments.

2.2 Significant Accounting Policies

2.2.1 Interest income and expense

Interest income and expense are recognized in profit or loss for interest-bearing financial instruments classified under amortized cost and fair value through other comprehensive income 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 Bank 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.

2.2.2 Fee and commission income

The Bank 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.

2.2.3 Dividend income

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

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.4 Financial assets and liabilities

Measurement methods

Initial recognition and measurement

Financial assets and financial liabilities are recognized when the Bank 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 Bank commits to purchase or sell the asset.

At initial recognition, the Bank 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 financial assets at fair value through other comprehensive income, 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 Bank 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.

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 ECL 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 Bank 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 Bank 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 classified under amortized cost and fair value through other comprehensive income, 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 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

2.2 Significant Accounting Policies (continued)

2.2.4 Financial assets and liabilities (continued)

2.2.4.1 Financial assets

(i) Classification and subsequent measurement

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

Based on these factors, the Bank 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 arising 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.

Business model: the business model reflects how the Bank manages the assets in order to generate cash flows. That is, whether the Bank'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 Bank in determining the business model for a group 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 Bank assesses whether the financial instruments' cash flows represent solely payments of principal and interest (the 'SPPI test'). In making this assessment, the Bank 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.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.4 Financial assets and liabilities *(continued)*

2.2.4.1 Financial assets *(continued)*

(i) Classification and subsequent measurement (continued)

Debt instruments *(continued)*

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

The Bank 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 Bank subsequently measures all equity investments at fair value through profit or loss, except where the Bank's management has elected, at initial recognition, to irrevocably designate an equity investment at fair value through other comprehensive income. The Bank'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 Bank'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'.

(ii) Impairment

The Bank 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 Bank recognizes a ECL 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.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.4 Financial assets and liabilities *(continued)*

2.2.4.1 Financial assets *(continued)*

(iii) Modification of loans

The Bank sometimes renegotiates or otherwise modifies the contractual cash flows of loans to customers. When this happens, the Bank assesses whether or not the new terms are substantially different to the original terms. The Bank 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 Bank 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 Bank 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 Bank 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).

(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 Bank transfers substantially all the risks and rewards of ownership, or (ii) the Bank neither transfers nor retains substantially all the risks and rewards of ownership and the Bank has not retained control.

Notes to the Financial Statements

For the year ended 31 December 2020

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

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.4 Financial assets and liabilities *(continued)*

2.2.4.1 Financial assets *(continued)*

(iv) Derecognition other than on a modification (continued)

The Bank 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 Bank:

- (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 Bank under standard repurchase agreements and securities lending and borrowing transactions are not derecognized because the Bank 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 Bank retains a subordinated residual interest.

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

2.2.4.2 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 Bank recognizes any expense incurred on the financial liability; when continuing involvement approach applies, see note 2.2.4.1 (iv); and
- Financial guarantee contracts and loan commitments (see note 2.2.5).

Notes to the Financial Statements

For the year ended 31 December 2020
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.4 Financial assets and liabilities *(continued)*

2.2.4.2 Financial liabilities *(continued)*

(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 Bank 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.

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

Loan commitments provided by the Bank are measured as the amount of the ECL allowance. The Bank 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 ECL allowance is recognized as provision. However, for contracts that include both a loan and an undrawn commitment and the Bank 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 ECL 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.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.6 Derivatives and hedging activities

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

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 Bank 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 Bank 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 Bank 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 Bank documents the economic relationship between hedging instruments and hedged items. The Bank documents its risk management objective and strategy for undertaking its hedge transactions. The Bank 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.

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.

Notes to the Financial Statements

For the year ended 31 December 2020
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

2.2 Significant Accounting Policies (continued)

2.2.6 Derivatives and hedging activities (continued)

Cash flow hedge (continued)

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.

2.2.7 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.

2.2.8 Property and equipment

The Bank'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 Bank 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.

Notes to the Financial Statements

For the year ended 31 December 2020
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2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.9 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.

2.2.10 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 Bank's investment property is situated, and the Bank 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 Bank 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 Bank recognizes the amount of any proceeds on disposal net of the carrying amount and related taxes in profit or loss for the period.

2.2.11 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 Bank 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.

2.2.12 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 Bank 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 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.13 Leases

Leases are recognized as a right-of-use asset and a corresponding liability at the date at which the leased asset is available for use by the Bank.

Contracts may contain both lease and non-lease components. The Bank allocates the consideration in the contract to the lease and non-lease components based on their relative stand-alone prices.

Assets and liabilities arising from a lease are initially measured on a present value basis. Lease liabilities include the net present value of the following lease payments:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable; and
- amounts expected to be payable by the Bank under residual value guarantees.

Lease payments to be made under reasonably certain extension options are also included in the measurement of the liability.

The lease payments are discounted using the interest rate implicit in the lease. If that rate cannot be readily determined, which is generally the case for leases in the Bank, the lessee's incremental borrowing rate is used, being the rate that the individual lessee would have to pay to borrow the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment with similar terms, security and conditions.

To determine the incremental borrowing rate, the Bank:

- where possible, uses recent third-party financing received by the individual lessee as a starting point, adjusted to reflect changes in financing conditions since third party financing was received; and
- makes adjustments specific to the lease, e.g. term, country, currency and security.

Lease payments are allocated between principal and finance cost. The finance cost is charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Right-of-use assets are measured at cost comprising the following:

- the amount of the initial measurement of lease liability;
- any lease payments made at or before the commencement date less any lease incentives received;
- any initial direct costs; and
- restoration costs.

Right-of-use assets are generally depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis. If the Bank is reasonably certain to exercise a purchase option, the right-of-use asset is depreciated over the underlying asset's useful life.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.14 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.

2.2.15 Provisions

Provisions are recognized when the Bank 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.

2.2.16 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 Bank's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the end of the reporting period.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.16 Current and deferred income taxes *(continued)*

(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 Bank 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.

2.2.17 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 Bank. 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.

2.2.18 Fiduciary activities

In activities where the Bank 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 Bank's financial statements.

2.2.19 Acceptances

Acceptances comprise the Bank'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.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.2 Significant Accounting Policies *(continued)*

2.2.20 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 Bank 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 Bank's employees. Contributions to the schemes by the Bank 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 Bank prior to his/her interest in the Bank's employer non-mandatory contributions vesting with the employee, the ongoing contributions payable by the Bank 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 Bank.

2.2.21 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.

2.2.22 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 Bank has determined the senior management team represented by the governor as its chief operating decision maker.

An operating segment is a component of the Bank 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 Bank. 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.

2.2.23 Foreign currency translation

HK\$ is the currency of the primary economic environment in which the Bank operates. Therefore, the Bank 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.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

2.3 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 Bank's accounting policies and the key sources of estimation uncertainty were as follow:

(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 Bank 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.

(c) Determination of lease term

In determining the lease term, management considers all facts and circumstances that create an economic incentive to exercise an extension option, or not exercise a termination option. Extension options (or periods after termination options) are only included in the lease term if the lease is reasonably certain to be extended (or not terminated).

For leases of retail stores, the following factors are normally the most relevant:

- If any leasehold improvements are expected to have significant remaining value, the Bank is typically reasonably certain to extend (or not terminate).
- Otherwise, the Bank considers other factors including historical leases durations and the costs and business disruption required to replace the leased asset.

The lease term is reassessed if an option is actually exercised (or not exercised) or the Bank becomes obliged to exercise (or not exercise) it. The assessment of reasonable certainty is only revised if a significant event or a significant change in circumstances occurs, which affects this assessment, and that is within the control of the lessee.

Notes to the Financial Statements

For the year ended 31 December 2020

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

3 FINANCIAL RISK MANAGEMENT

The Bank'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 Bank's aim is to achieve an appropriate balance between risk and return and minimize potential adverse effects on the Bank's financial performance.

The Bank'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 Bank 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 Bank. 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 Bank are credit risk, market risk, liquidity risk and operational risk, etc. Market risk also includes interest rate risk, foreign exchange risk and other price risk.

3.1 Credit risk

Credit risk, the risk that a borrower or counterparty of the Bank will be unable or unwilling to honor a repayment obligation, is one of the key risks encountered by the Bank as the Bank'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 Bank'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 Bank 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 Bank.

3.1.1 Credit risk management

The Bank'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.

In 2020, Risk Management Department completed various thematic reviews in response to Covid-19. The scope covered sectors under deep impact in the pandemic, including review on small and medium enterprises, medium size corporations, exposure related to energy industry, loans secured by listed shares, as well as companies under debt relief measures. Some customers were identified with higher risk, as they experienced sharp drop in profit or net loss, cease of business, and laid off of staffs. These customers were put into a watch list, and those in highest risk level were classified as Special Mention or closely monitored monthly. Regular reporting of situation is submitted to Senior Management for their attention.

(a) Loans and advances to customers

As for corporate loans, the Bank'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 Bank 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 Bank 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 Bank 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 Bank's relationship manager is the person primarily responsible for post-loan management. The Bank 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 Bank 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.

Notes to the Financial Statements

For the year ended 31 December 2020
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.1 Credit risk management *(continued)*

(a) Loans and advances to customers (continued)

For retail credit assets, the Bank 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 Bank is in charge of the operation and management of credit card business. Credit Card Centre of the Bank 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.

(b) Treasury business

For treasury business, the Bank 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 Bank 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 Bank 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 Bank 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 Bank 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 Bank (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 Bank 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 Bank concludes foreign exchange and interest rate contracts with other financial institutions and clients.

The Bank 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 2020
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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 HKMA, the Bank has established a loan credit risk classification system and performs credit risk management based on loan classification in one of five categories. The Bank 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 Bank 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 Bank 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 Bank 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 Bank 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 Bank.

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

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.1 Credit risk management *(continued)*

(e) Credit risk measurement (continued)

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. An approximated PD is determined by management to represent the probability of default for unrated exposures.

The Bank'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 Bank'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 Bank.

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 Bank 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 Bank 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 Bank 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 2020
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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 Bank 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) Days past due

Different levels of days 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.

Notes to the Financial Statements

For the year ended 31 December 2020
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.2 Expected credit loss measurement *(continued)*

3.1.2.1 Significant increase in credit risk (SICR) *(continued)*

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

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 Bank.

3.1.2.2 Definition of default and credit-impaired assets

The Bank 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 Bank’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, 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 Bank expects to be owed at the time of default. For example, for a revolving commitment, the Bank 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 Bank’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.

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For the year ended 31 December 2020
(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)*

3.1.2.3 Measuring ECL – Explanation of inputs, assumptions and estimation techniques *(continued)*

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, LGDs are typically set at product level due to the limited differentiation in recoveries achieved across different borrowers. These LGDs are influenced by collection strategies, including contracted debt sales and price.

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 Bank 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 to come up with the base economic scenario over the next five years are gathered from different sources including economics team of the Bank of Communications Co. Ltd., 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 Bank'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. At 31 December 2019 and 31 December 2020, the Bank concluded that three scenarios are used in the calculation. The scenario weightings are determined by expert credit judgement, taking account of the range of possible outcomes each chosen scenario is representative of.

Following this assessment, the Bank 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 of the economic scenarios are based on estimates to future economic conditions which are sensitive to changes in these conditions caused by macro events, including the COVID-19 pandemic and geopolitical developments. They are therefore subject to a high degree of inherent uncertainty and therefore the actual outcomes may be significantly different to those projected. The Bank considers these forecasts to represent its best estimate of the possible outcomes and has analyzed the non-linearities and asymmetries within the Bank'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 2020
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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 *(continued)*

Economic variable assumptions

The COVID-19 pandemic has created unprecedented economic and social challenges to all regions of the world. In order to limit the spread of COVID-19, different restrictions (including social distancing or lock down) are implemented by governments over the world which resulted in a sharp decline in global economic activities in the year of 2020. At the same time, different forms of relief measures have also been rolled out by governments around the world at unprecedented scale and speed to prevent the further deterioration and support the recovery of economies. Besides, the development of different COVID-19 vaccines are completed. COVID-19 vaccination programme is launched in different regions. It is expected that global economic activities would gradually recover over time.

The above development of COVID-19 pandemic and geopolitical environment changes in the year of 2020 have added complications to the estimates of the economic scenarios and caused the Bank to revisit its economic scenarios and probability weightings in calculating ECL.

The Bank has continued to adopt the use of three economic scenarios for all portfolios. They represent a most likely scenario (i.e. the "Base" scenario) and two, less likely, "outer" scenarios on either side of the Base scenario, referred to as an "Upside" and a "Downside" scenario respectively. The two outer scenarios, the "Upside" and the "Downside", have been determined with reference to the historical observations of the macro-economic factors and the Bank's historical loss experience. The "Base" scenario can be described as follows:

After a severe economic shock to the global economy is observed in 2020, a notable recovery is expected in 2021 as COVID-19 vaccination programme is launched subsequently, pandemic containment measures will be loosened and global economic activities could be resumed accordingly. A moderate growth is expected afterwards as relief measures are expected to cease gradually. GDP in most regions is contracted in 2020 and is expected to rebound in 2021.

The most significant period-end assumptions used for the ECL estimate as at 31 December 2020 are set out below.

		2021	2022	2023	2024	2025
Hong Kong CPI	Base	2.00%	2.00%	2.00%	2.00%	2.00%
	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	5.00%	4.50%	4.00%	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%
Mainland China Real GDP (first difference)	Base	6.08%	-2.68%	-0.06%	-0.09%	-0.15%
	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	7.35%	-0.14%	-0.68%	-0.36%	-0.07%
	Upside	1.08%	0.69%	-0.04%	0.24%	-0.59%
	Downside	-3.12%	0.81%	1.02%	0.98%	-0.44%

However, the level of recovery is highly uneven in the global economy. Mainland China's GDP will be expanded largely while a weak growth is forecasted in Hong Kong. The unemployment rate is expected to drop slightly in 2021 in most of the regions compared with the high level of 2020. It is forecasted to return to the growth level similar to that in 2019 gradually over the future years.

In consideration of the above development of COVID-19 pandemic in the world, the Bank has considered its impact and revisited the probability weightings in calculating ECL.

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For the year ended 31 December 2020
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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 *(continued)*

Economic variable assumptions *(continued)*

The weightings assigned to each economic scenario as at 31 December 2020 were as follows:

Upside	Base	Downside
10%	50%	40%

The most significant period-end assumptions used for the ECL estimate as at 31 December 2019 are set out below.

		2020	2021	2022	2023	2024
Hong Kong CPI	Base	2.50%	2.50%	2.50%	2.50%	2.50%
	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	3.70%	4.00%	4.30%	4.50%	4.50%
	Upside	2.77%	2.20%	4.70%	6.25%	4.95%
	Downside	5.09%	7.32%	7.94%	6.81%	5.59%
Mainland China Real GDP (first difference)	Base	-0.10%	0.00%	-0.20%	-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	-0.26%	-0.34%	-0.19%	0.02%	0.04%
	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 2019 were as follows:

Upside	Base	Downside
20%	65%	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.

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For the year ended 31 December 2020

(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 2020	As at 31 December 2019
Change from Base to Probability-weighted ECL		
Probability-weighted ECL	943,930	477,417
Base ECL	520,127	480,756
Difference in amount	423,803	(3,339)
Difference in percentage	44.9%	(0.7%)

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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

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 Bank's maximum exposure of credit risk on these assets.

Corporate Loan	2020			Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	
Investment Grade	25,720,451	–	–	25,720,451
Standard Monitoring	31,721,184	622,377	–	32,343,561
Special Monitoring	–	211,392	–	211,392
Defaults	–	–	58,071	58,071
Unrated	34,866,935	945,225	–	35,812,160
Gross carrying amount	92,308,570	1,778,994	58,071	94,145,635
ECL allowance	(297,231)	(80,938)	(25,418)	(403,587)
Carrying amount	92,011,339	1,698,056	32,653	93,742,048

Corporate Loan	2019			Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	
Investment Grade	10,474,278	–	–	10,474,278
Standard Monitoring	15,201,423	108,155	–	15,309,578
Special Monitoring	13,529	181,967	–	195,496
Defaults	–	–	32,605	32,605
Unrated	18,333,628	34,338	–	18,367,966
Gross carrying amount	44,022,858	324,460	32,605	44,379,923
ECL allowance	(138,330)	(16,797)	(14,316)	(169,443)
Carrying amount	43,884,528	307,663	18,289	44,210,480

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For the year ended 31 December 2020
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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)

	2020			Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	
Retail loan				
Investment Grade	43,011,299	12,279	–	43,023,578
Standard Monitoring	110,790	577,434	–	688,224
Special Monitoring	–	34,446	–	34,446
Defaults	–	–	47,811	47,811
Gross carrying amount	43,122,089	624,159	47,811	43,794,059
ECL allowance	(83,968)	(68,427)	(18,815)	(171,210)
Carrying amount	43,038,121	555,732	28,996	43,622,849

	2019			Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	
Retail loan				
Investment Grade	34,672,630	22,340	–	34,694,970
Standard Monitoring	158,575	204,003	–	362,578
Special Monitoring	–	20,337	–	20,337
Defaults	–	–	29,783	29,783
Gross carrying amount	34,831,205	246,680	29,783	35,107,668
ECL allowance	(90,033)	(43,605)	(14,329)	(147,967)
Carrying amount	34,741,172	203,075	15,454	34,959,701

	2020			Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	
Due from banks and other financial institutions				
Investment Grade	19,715,245	–	–	19,715,245
Standard Monitoring	387,622	–	–	387,622
Gross carrying amount	20,102,867	–	–	20,102,867
ECL allowance	(8,131)	–	–	(8,131)
Carrying amount	20,094,736	–	–	20,094,736

	2019			Total
	Stage 1 12 month ECL	Stage 2 Lifetime ECL	Stage 3 Lifetime ECL	
Due from banks and other financial institutions				
Investment Grade	17,676,217	–	–	17,676,217
Gross carrying amount	17,676,217	–	–	17,676,217
ECL allowance	(8,309)	–	–	(8,309)
Carrying amount	17,667,908	–	–	17,667,908

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For the year ended 31 December 2020
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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)*

	2020			Total
	Stage 1	Stage 2	Stage 3	
Debt securities at fair value through other comprehensive income	12 month ECL	Lifetime ECL	Lifetime ECL	
Investment Grade	128,410,681	–	–	128,410,681
Standard Monitoring	2,327,684	–	–	2,327,684
Unrated	71,199,761	–	–	71,199,761
Gross carrying amount	201,938,126	–	–	201,938,126
ECL allowance	(318,962)	–	–	(318,962)
Carrying amount	201,619,164	–	–	201,619,164

	2019			Total
	Stage 1	Stage 2	Stage 3	
Debt securities at fair value through other comprehensive income	12 month ECL	Lifetime ECL	Lifetime ECL	
Investment Grade	83,818,392	–	–	83,818,392
Unrated	38,413,916	–	–	38,413,916
Gross carrying amount	122,232,308	–	–	122,232,308
ECL allowance	(121,331)	–	–	(121,331)
Carrying amount	122,110,977	–	–	122,110,977

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.

3.1.3.2 Maximum exposure to credit risk – Financial instruments

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

	Maximum exposure to credit risk	
	2020	2019
Financial assets at fair value through profit or loss		
Derivative financial instruments	905,433	874,964
Government bonds	–	189,962
Total	905,433	1,064,926

Notes to the Financial Statements

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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

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

The Bank 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 reviews, 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 Bank employs a range of policies and practices to mitigate credit risk. The most useful practice is to accept collaterals. The Bank 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; and
- 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 Bank will seek additional collaterals from the counterparties as soon as impairment indicators are noted for the relevant individual loans and advances.

For loans guaranteed by a third-party guarantor, the Bank 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.

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For the year ended 31 December 2020
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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)**

The Bank closely monitors collateral held for financial assets considered to be credit-impaired, as it becomes more likely that the Bank will take possession of collateral to mitigate potential credit losses. The fair value is capped at lower of carrying amount and fair value. Financial assets that are credit-impaired and related collateral held in order to mitigate potential losses are shown below:

As at 31 December 2020:

	Gross exposure	ECL allowance	Carrying amount	Fair value of collateral held
Loans to individuals	47,811	(18,815)	28,996	27,245
Loans to corporate entities	58,071	(25,418)	32,653	17,327
	105,882	(44,233)	61,649	44,572

As at 31 December 2019:

	Gross exposure	ECL allowance	Carrying amount	Fair value of collateral held
Loans to individuals	29,783	(14,329)	15,454	13,687
Loans to corporate entities	32,605	(14,316)	18,289	10,560
	62,388	(28,645)	33,743	24,247

(b) Master netting arrangements

The Bank 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 Bank'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.

3.1.4 Movements of gross carrying amount and ECL allowance

The ECL 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; and
- 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).

Notes to the Financial Statements

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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Movements of gross carrying amount and ECL allowance *(continued)*

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

Movement of gross amount – Corporate Loan

Corporate Loan	Stage 1	Stage 2	Stage 3	Total
Gross carrying amount as at 1 January 2020	44,022,858	324,460	32,605	44,379,923
Transfers:				
Transfer from Stage 1 to Stage 2	(630,515)	630,515	–	–
Transfer from Stage 1 to Stage 3	(28,994)	–	28,994	–
Transfer from Stage 2 to Stage 1	70,871	(70,871)	–	–
Transfer from Stage 2 to Stage 3	–	(5,254)	5,254	–
New financial assets originated or purchased, assets derecognized, repayments and further lending <i>(Note)</i>	48,885,110	900,144	(8,756)	49,776,498
Foreign exchange and other movements	(10,760)	–	(26)	(10,786)
Gross carrying amount as at 31 December 2020	92,308,570	1,778,994	58,071	94,145,635

Note: The balances include the corporate loans originated or purchased in the year and subsequently transferred between stage 1, stage 2 and stage 3 during the year.

Corporate Loan	Stage 1	Stage 2	Stage 3	Total
Gross carrying amount as at 1 January 2019	39,535,107	79,561	17,900	39,632,568
Transfers:				
Transfer from Stage 1 to Stage 2	(124,257)	124,257	–	–
Transfer from Stage 1 to Stage 3	(12,789)	–	12,789	–
Transfer from Stage 2 to Stage 1	21,431	(21,431)	–	–
Transfer from Stage 2 to Stage 3	–	(2,390)	2,390	–
New financial assets originated or purchased, assets derecognized, repayments and further lending <i>(Note)</i>	4,648,945	144,463	(452)	4,792,956
Foreign exchange and other movements	(45,579)	–	(22)	(45,601)
Gross carrying amount as at 31 December 2019	44,022,858	324,460	32,605	44,379,923

Note: The balances include the corporate loans originated or purchased in the year and subsequently transferred between stage 1, stage 2 and stage 3 during the year.

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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Movements of gross carrying amount and ECL allowance *(continued)*

Movement of ECL allowance – Corporate Loan

Corporate Loan	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
ECL allowance as at 1 January 2020	138,330	16,797	14,316	169,443
Transfers:				
Transfer from Stage 1 to Stage 2	(5,758)	5,758	–	–
Transfer from Stage 1 to Stage 3	(103)	–	103	–
Transfer from Stage 2 to Stage 1	8,584	(8,584)	–	–
Transfer from Stage 2 to Stage 3	–	(412)	412	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	171,491	41,291	(859)	211,923
Changes in PDs/LGDs/EADs	(14,429)	25,813	10,729	22,113
Unwind of discount	–	395	–	395
Foreign exchange and other movements	(884)	(120)	717	(287)
ECL allowance amount as at 31 December 2020	297,231	80,938	25,418	403,587

Corporate loan	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
ECL allowance as at 1 January 2019	141,821	8,578	8,236	158,635
Transfers:				
Transfer from Stage 1 to Stage 2	(941)	941	–	–
Transfer from Stage 1 to Stage 3	(107)	–	107	–
Transfer from Stage 2 to Stage 1	2,317	(2,317)	–	–
Transfer from Stage 2 to Stage 3	–	(374)	374	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	17,600	3,534	1,705	22,839
Changes in PDs/LGDs/EADs	(22,040)	6,274	3,799	(11,967)
Unwind of discount	–	203	–	203
Foreign exchange and other movements	(320)	(42)	95	(267)
ECL allowance amount as at 31 December 2019	138,330	16,797	14,316	169,443

Notes to the Financial Statements

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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Movements of gross carrying amount and ECL allowance *(continued)*

Movement of gross amount – Retail Loan

Retail Loan	Stage 1	Stage 2	Stage 3	Total
Gross carrying amount as at 1 January 2020	34,831,205	246,680	29,783	35,107,668
Transfers:				
Transfer from Stage 1 to Stage 2	(495,487)	495,487	–	–
Transfer from Stage 1 to Stage 3	(20,502)	–	20,502	–
Transfer from Stage 2 to Stage 1	122,902	(122,902)	–	–
Transfer from Stage 2 to Stage 3	–	(8,188)	8,188	–
Transfer from Stage 3 to Stage 1	5	–	(5)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending <i>(Note)</i>	8,686,009	13,097	(6,456)	8,692,650
Write-offs	–	–	(4,203)	(4,203)
Foreign exchange and other movements	(2,043)	(15)	2	(2,056)
Gross carrying amount as at 31 December 2020	43,122,089	624,159	47,811	43,794,059

Note: The balances include the retail loans originated or purchased in the year and subsequently transferred between stage 1, stage 2 and stage 3 during the year.

Retail Loan	Stage 1	Stage 2	Stage 3	Total
Gross carrying amount as at 1 January 2019	28,040,662	201,287	46,416	28,288,365
Transfers:				
Transfer from Stage 1 to Stage 2	(185,428)	185,428	–	–
Transfer from Stage 1 to Stage 3	(18,522)	–	18,522	–
Transfer from Stage 2 to Stage 1	89,474	(89,474)	–	–
Transfer from Stage 2 to Stage 3	–	(1,357)	1,357	–
Transfer from Stage 3 to Stage 1	74	–	(74)	–
Transfer from Stage 3 to Stage 2	–	495	(495)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending <i>(Note)</i>	6,910,503	(49,586)	(29,148)	6,831,769
Write-offs	–	–	(6,794)	(6,794)
Foreign exchange and other movements	(5,558)	(113)	(1)	(5,672)
Gross carrying amount as at 31 December 2019	34,831,205	246,680	29,783	35,107,668

Note: The balances include the retail loans originated or purchased in the year and subsequently transferred between stage 1, stage 2 and stage 3 during the year.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Movements of gross carrying amount and ECL allowance *(continued)*

Movement of ECL allowance – Retail Loan

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Retail Loan				
ECL allowance amount as at 1 January 2020	90,033	43,605	14,329	147,967
Transfers:				
Transfer from Stage 1 to Stage 2	(1,155)	1,155	–	–
Transfer from Stage 1 to Stage 3	(58)	–	58	–
Transfer from Stage 2 to Stage 1	26,588	(26,588)	–	–
Transfer from Stage 2 to Stage 3	–	(2,816)	2,816	–
Transfer from Stage 3 to Stage 1	4	–	(4)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	16,963	8,588	11	25,562
Unwind of discount	–	771	–	771
Changes in PDs/LGDs/EADs	(48,283)	43,676	5,112	505
Recoveries of loans written-off in previous years	–	–	392	392
Write-offs	–	–	(4,203)	(4,203)
Foreign exchange and other movements	(124)	36	304	216
ECL allowance amount as at 31 December 2020	83,968	68,427	18,815	171,210

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Retail Loan				
ECL allowance amount as at 1 January 2019	34,877	23,384	15,318	73,579
Transfers:				
Transfer from Stage 1 to Stage 2	(409)	409	–	–
Transfer from Stage 1 to Stage 3	(44)	–	44	–
Transfer from Stage 2 to Stage 1	15,529	(15,529)	–	–
Transfer from Stage 2 to Stage 3	–	(266)	266	–
Transfer from Stage 3 to Stage 1	13	–	(13)	–
Transfer from Stage 3 to Stage 2	–	506	(506)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	22,116	1,482	(845)	22,753
Unwind of discount	–	558	–	558
Changes in PDs/LGDs/EADs	18,127	33,178	6,546	57,851
Write-offs	–	–	(6,794)	(6,794)
Foreign exchange and other movements	(176)	(117)	313	20
ECL allowance amount as at 31 December 2019	90,033	43,605	14,329	147,967

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT (continued)

3.1 Credit risk (continued)

3.1.4 Movements of gross carrying amount and ECL allowance (continued)

Movement of ECL allowance – Loans and advances to customers

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Loans and advances to customers				
ECL allowance amount as at 1 January 2020	228,363	60,402	28,645	317,410
Transfers:				
Transfer from Stage 1 to Stage 2	(6,913)	6,913	–	–
Transfer from Stage 1 to Stage 3	(161)	–	161	–
Transfer from Stage 2 to Stage 1	35,172	(35,172)	–	–
Transfer from Stage 2 to Stage 3	–	(3,228)	3,228	–
Transfer from Stage 3 to Stage 1	4	–	(4)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	188,454	49,879	(848)	237,485
Changes in PDs/LGDs/EADs	(62,712)	69,489	15,841	22,618
Unwind of discount	–	1,166	–	1,166
Recoveries of loans written-off in previous years	–	–	392	392
Write-offs	–	–	(4,203)	(4,203)
Foreign exchange and other movements	(1,008)	(84)	1,021	(71)
ECL allowance amount as at 31 December 2020	381,199	149,365	44,233	574,797

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Loans and advances to customers				
ECL allowance amount as at 1 January 2019	176,698	31,962	23,554	232,214
Transfers:				
Transfer from Stage 1 to Stage 2	(1,350)	1,350	–	–
Transfer from Stage 1 to Stage 3	(151)	–	151	–
Transfer from Stage 2 to Stage 1	17,846	(17,846)	–	–
Transfer from Stage 2 to Stage 3	–	(640)	640	–
Transfer from Stage 3 to Stage 1	13	–	(13)	–
Transfer from Stage 3 to Stage 2	–	506	(506)	–
New financial assets originated or purchased, assets derecognized, repayments and further lending	39,716	5,016	860	45,592
Changes in PDs/LGDs/EADs	(3,913)	39,452	10,345	45,884
Unwind of discount	–	761	–	761
Write-offs	–	–	(6,794)	(6,794)
Foreign exchange and other movements	(496)	(159)	408	(247)
ECL allowance amount as at 31 December 2019	228,363	60,402	28,645	317,410

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Movements of gross carrying amount and ECL allowance *(continued)*

Movement of gross carrying amount – Due from banks and other financial institutions

Due from banks and other financial institutions	Stage 1	Stage 2	Stage 3	Total
Gross carrying amount as at 1 January 2020	17,676,217	–	–	17,676,217
New financial assets originated or purchased, assets derecognized, repayments and further lending	2,314,015	–	–	2,314,015
Foreign exchange and other movements	112,635			112,635
Gross carrying amount as at 31 December 2020	20,102,867	–	–	20,102,867
Due from banks and other financial institutions	Stage 1	Stage 2	Stage 3	Total
Gross carrying amount as at 1 January 2019	25,088,522	–	–	25,088,522
New financial assets originated or purchased, assets derecognized, repayments and further lending	(7,412,305)	–	–	(7,412,305)
Gross carrying amount as at 31 December 2019	17,676,217	–	–	17,676,217

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT (continued)

3.1 Credit risk (continued)

3.1.4 Movements of gross carrying amount and ECL allowance (continued)

Movement of ECL allowance – Due from banks and other financial institutions

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Due from banks and other financial institutions				
ECL allowance amount as at 1 January 2020	8,309	–	–	8,309
New financial assets originated or purchased, assets derecognized, repayments and further lending	(2,054)	–	–	(2,054)
Change in PDs/LGDs/EADs	1,859	–	–	1,859
Foreign exchange and other movements	17	–	–	17
ECL allowance amount as at 31 December 2020	8,131	–	–	8,131

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Due from banks and other financial institutions				
ECL allowance amount as at 1 January 2019	6,085	–	–	6,085
New financial assets originated or purchased, assets derecognized, repayments and further lending	1,868	–	–	1,868
Change in PDs/LGDs/EADs	356	–	–	356
Foreign exchange and other movements	–	–	–	–
ECL allowance amount as at 31 December 2019	8,309	–	–	8,309

Movement of gross amount – Debt securities at fair value through other comprehensive income

	Stage 1	Stage 2	Stage 3	Total
Debt securities at fair value through other comprehensive income				
Gross carrying amount as at 1 January 2020	122,232,308	–	–	122,232,308
New financial assets originated or purchased, assets derecognized, repayments and further lending	77,265,950	–	–	77,265,950
Foreign exchange and other movements	2,439,868	–	–	2,439,868
Gross carrying amount as at 31 December 2020	201,938,126	–	–	201,938,126

	Stage 1	Stage 2	Stage 3	Total
Debt securities at fair value through other comprehensive income				
Gross carrying amount as at 1 January 2019	109,305,072	–	–	109,305,072
New financial assets originated or purchased, assets derecognized, repayments and further lending	13,396,487	–	–	13,396,487
Foreign exchange and other movements	(469,251)	–	–	(469,251)
Gross carrying amount as at 31 December 2019	122,232,308	–	–	122,232,308

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.4 Movements of gross carrying amount and ECL allowance *(continued)*

Movement of ECL allowance – Debt securities at fair value through other comprehensive income

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Debt securities at fair value through other comprehensive income				
ECL allowance amount as at 1 January 2020	121,331	–	–	121,331
New financial assets originated or purchased, assets derecognized, repayments and further lending	141,029	–	–	141,029
Changes in PDs/LGDs/EADs	55,984	–	–	55,984
Foreign exchange and other movements	618	–	–	618
ECL allowance amount as at 31 December 2020	318,962	–	–	318,962

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Debt securities at fair value through other comprehensive income				
ECL allowance amount as at 1 January 2019	61,089	–	–	61,089
New financial assets originated or purchased, assets derecognized, repayments and further lending	52,428	–	–	52,428
Changes in PDs/LGDs/EADs	7,814	–	–	7,814
ECL allowance amount as at 31 December 2019	121,331	–	–	121,331

	Stage 1	Stage 2	Stage 3	Total
Financial guarantees and credit related commitment				
Gross carrying amount as at 31 December 2020	15,277,026	199,064	–	15,476,090
Gross carrying amount as at 31 December 2019	11,780,758	9,303	–	11,790,061

	Stage 1 12-month ECL allowance	Stage 2 Lifetime ECL allowance	Stage 3 Lifetime ECL allowance	Total
Financial guarantees and credit related commitment				
ECL allowance amount as at 31 December 2020	14,890	9,080	–	23,970
ECL allowance amount as at 31 December 2019	12,780	2,092	–	14,872

Notes to the Financial Statements

For the year ended 31 December 2020
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

3.1.5 Write-off policy

The Bank 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 Bank'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 Bank may write-off financial assets that are still subject to enforcement activity. The Bank 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.

3.1.6 Derivative instruments

The Bank 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 Bank's market transactions on any single day.

3.1.7 Repossessed assets

Repossessed assets are collateral of the outstanding indebtedness that the Bank takes possession of the collateral assets through 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 2020 and 2019, there was no repossessed asset that being held by the Bank.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.1 Credit risk *(continued)*

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

The Bank 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

	2020	2019
Mainland China	10,613,016	10,630,761
Hong Kong	126,580,180	68,517,199
Others	896,271	371,065
	138,089,467	79,519,025

3.2 Market risk

3.2.1 Overview

The Bank 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 and exchange rates products, all of which are exposed to market fluctuations and changes in interest rates and foreign exchange rates.

The Bank 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 Bank'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 Bank 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 non-trading account consists of the investments purchased by the Bank 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 Bank 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 Bank to monitor the market risk of its overall businesses. In addition, through adequate pricing management and asset allocation, the Bank strived to maximize its rate of return while keeping its risks under control.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.1 Overview *(continued)*

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

As part of market risk management, the Bank 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:

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 Bank 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 Bank's portfolios is as follows:

Items	For the year ended 31 December 2020			
	31 December 2020	Average	Maximum	Minimum
VaR	2,219	4,819	18,276	1,381
– Interest rate risk	51	508	2,244	51
– Foreign exchange risk	2,219	4,910	18,104	1,929

Items	For the year ended 31 December 2019			
	31 December 2019	Average	Maximum	Minimum
VaR	1,422	1,071	3,324	182
– Interest rate risk	1,519	1,465	2,360	4
– Foreign exchange risk	2,111	1,797	4,182	732

3.2.3 Sensitivity tests

Interest rate sensitivity test

The Bank performs interest rate sensitivity analysis on net interest income for the Bank 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 Bank calculates the changes in net interest income for the year on a monthly basis.

Notes to the Financial Statements

For the year ended 31 December 2020
(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)*

Interest rate sensitivity test (continued)

The table below illustrates the impact to net interest income of the coming year of the Bank based on the structure of interest bearing assets and liabilities as at 31 December 2020 and 31 December 2019, 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 2020	As at 31 December 2019
+100 basis points parallel shift in yield curves	(662,389)	(174,814)
-100 basis points parallel shift in yield curves	662,389	174,814

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 Bank 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.

Foreign exchange sensitivity test

The Bank performs exchange rate sensitivity analysis on net profit and equity for the Bank 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 RMB, GBP, AUD and EUR spot and forward rates against HK\$ by 5%, the Bank 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 RMB, GBP, AUD and EUR spot and forward rates against HK\$ by 5% on the Bank's net profit and equity:

	Expected changes in net profit and equity	
	As at 31 December 2020	As at 31 December 2019
5% appreciation of RMB	(15,350)	(796,224)
5% depreciation of RMB	15,350	796,224

Notes to the Financial Statements

For the year ended 31 December 2020
(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 *(continued)*

	Expected changes in net profit and equity	
	As at 31 December 2020	As at 31 December 2019
5% appreciation of GBP	111,703	54,480
5% depreciation of GBP	(111,703)	(54,480)
5% appreciation of AUD	877,418	1,022,361
5% depreciation of AUD	(877,418)	(1,022,361)
5% appreciation of EUR	186,983	91,979
5% depreciation of EUR	(186,983)	(91,979)

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 Bank 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.

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

Notes to the Financial Statements

For the year ended 31 December 2020
(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 2020							
Assets							
Cash and balances with central bank	–	–	–	–	–	8,438,950	8,438,950
Due from banks and other financial institutions	18,627,299	1,312,750	154,687	–	–	–	20,094,736
Financial assets at fair value through profit or loss	–	–	–	–	–	905,433	905,433
Financial assets at fair value through other comprehensive income	27,695,463	51,620,765	13,574,987	69,398,885	39,648,026	9,697	201,947,823
Loans and advances to customers	123,037,458	10,559,020	1,532,412	267,350	2,118,430	–	137,514,670
Other financial assets	–	–	–	–	–	3,650,086	3,650,086
Total financial assets	169,360,220	63,492,535	15,262,086	69,666,235	41,766,456	13,004,166	372,551,698
Liabilities							
Due to banks and other financial institutions	21,031,885	32,892,562	17,473,034	–	–	262,195	71,659,676
Due to customers	145,064,190	71,038,353	26,728,791	2,490	–	2,916,085	245,749,909
Financial liabilities at fair value through profit or loss	–	–	–	–	–	2,783,985	2,783,985
Lease liabilities	14,086	28,230	82,565	111,740	1,712	–	238,333
Other financial liabilities	–	–	–	–	–	5,135,147	5,135,147
Total financial liabilities	166,110,161	103,959,145	44,284,390	114,230	1,712	11,097,412	325,567,050
Total interest sensitivity gap	3,250,059	(40,466,610)	(29,022,304)	69,552,005	41,764,744	1,906,754	46,984,648

Notes to the Financial Statements

For the year ended 31 December 2020
(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 2019							
Assets							
Cash and balances with central bank	–	–	–	–	–	1,094,956	1,094,956
Due from banks and other financial institutions	6,675,582	10,992,326	–	–	–	–	17,667,908
Financial assets at fair value through profit or loss	–	155,478	34,484	–	–	874,964	1,064,926
Financial assets at fair value through other comprehensive income	21,797,930	51,856,957	11,323,189	24,118,908	13,135,324	9,965	122,242,273
Loans and advances to customers	71,775,867	4,803,560	384,790	337,202	1,900,196	–	79,201,615
Other financial assets	–	–	–	–	–	5,418,372	5,418,372
Total financial assets	100,249,379	67,808,321	11,742,463	24,456,110	15,035,520	7,398,257	226,690,050
Liabilities							
Due to banks and other financial institutions	7,102,118	20,060,545	1,556,264	–	–	17,643	28,736,570
Due to customers	104,042,804	48,076,879	16,294,765	1,819	–	2,339,022	170,755,289
Financial liabilities at fair value through profit or loss	–	–	–	–	–	1,168,798	1,168,798
Lease liabilities	15,241	29,375	103,545	152,287	1,040	–	301,488
Other financial liabilities	–	–	–	–	–	4,378,083	4,378,083
Total financial liabilities	111,160,163	68,166,799	17,954,574	154,106	1,040	7,903,546	205,340,228
Total interest sensitivity gap	(10,910,784)	(358,478)	(6,212,111)	24,302,004	15,034,480	(505,289)	21,349,822

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For the year ended 31 December 2020
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.2 Market risk *(continued)*

3.2.5 Foreign exchange risk

The Bank conducts the majority of its businesses in HK\$, with certain foreign transactions in USD, RMB and other currencies. The Bank 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 Bank's exposure to foreign exchange risk at the end of the year. The tables show the Bank'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 2020					
Assets					
Cash and balances with central bank	8,030,743	22,900	373,343	11,964	8,438,950
Due from banks and other financial institutions	4,059,565	161,938	11,111,474	4,761,759	20,094,736
Financial assets at fair value through profit or loss	706,909	180	198,292	52	905,433
Financial assets at fair value through other comprehensive income	7,625,263	23,604,208	139,985,459	30,732,893	201,947,823
Loans and advances to customers	110,453,320	251,672	26,792,069	17,609	137,514,670
Other financial assets	1,776,343	332,782	1,404,820	136,141	3,650,086
Total financial assets	132,652,143	24,373,680	179,865,457	35,660,418	372,551,698
Liabilities					
Due to banks and other financial institutions	3,893,807	439,709	61,587,129	5,739,031	71,659,676
Due to customers	171,793,292	24,091,111	42,656,866	7,208,640	245,749,909
Financial liabilities at fair value through profit or loss	1,125,543	123	1,658,319	–	2,783,985
Lease liabilities	238,333	–	–	–	238,333
Other financial liabilities	3,553,950	149,745	1,293,370	138,082	5,135,147
Total financial liabilities	180,604,925	24,680,688	107,195,684	13,085,753	325,567,050
Net position	(47,952,782)	(307,008)	72,669,773	22,574,665	46,984,648

Notes to the Financial Statements

For the year ended 31 December 2020
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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 2019					
Assets					
Cash and balances with central bank	1,053,928	24,047	9,960	7,021	1,094,956
Due from banks and other financial institutions	14,400,318	231,532	694,820	2,341,238	17,667,908
Financial assets at fair value through profit or loss	771,072	189,970	103,826	58	1,064,926
Financial assets at fair value through other comprehensive income	9,868,713	11,696,443	73,939,649	26,737,468	122,242,273
Loans and advances to customers	68,270,613	276,087	10,637,366	17,549	79,201,615
Other financial assets	4,424,277	133,769	789,592	70,734	5,418,372
Total financial assets	98,788,921	12,551,848	86,175,213	29,174,068	226,690,050
Liabilities					
Due to banks and other financial institutions	6,246,364	24,006	22,336,912	129,288	28,736,570
Due to customers	101,926,676	26,899,726	34,250,657	7,678,230	170,755,289
Financial liabilities at fair value through profit or loss	973,920	–	194,862	16	1,168,798
Lease liabilities	301,488	–	–	–	301,488
Other financial liabilities	1,983,634	1,552,595	756,883	84,971	4,378,083
Total financial liabilities	111,432,082	28,476,327	57,539,314	7,892,505	205,340,228
Net position	(12,643,161)	(15,924,479)	28,635,899	21,281,563	21,349,822

3.2.6 Other price risk

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

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk

3.3.1 Overview

Liquidity risk is the risk that the Bank 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 Bank'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 Bank 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. The Bank set limits on the minimum proportion of funds to meet such calls and on the minimum level of interbank and other borrowing facilities that should be in place to cover different levels of unexpected withdrawals.

3.3.2 Liquidity risk management process

Funding liquidity risk relates to the Bank's ability to fulfill its obligations arising from financial liabilities as they fall due, or its ability to fulfill maturing funding needs, which subsequently affects the Bank's capacity to support deposit withdrawal or drawdown on loan commitments. Effective liquidity risk management helps to sustain the expansion of the Bank's business with liquidity cost and risk under control. The Bank 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 Bank 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 Bank's funding sources is customer deposit. The Bank strives to build up core deposits while diversifying funding sources via various funding channels to enhance financing capacity. Regarding liquidity arrangement with parent bank, the Bank performs regular funding transfer with parent bank 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 bank has set up groupwide internal limits to control the Bank's reliance on parent bank's funding.

The majority of the liquidity risk of the Bank 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 Bank closely monitors off-balance sheet funding obligations (such as commitments or letters of guarantee) and assesses their impact to our liquidity capacity. Furthermore, the Bank strives to maintain high marketability of the asset portfolio to allow prompt monetization in case of unforeseeable liquidity crunch in the market.

The Bank has in place various limits and indicators for liquidity risk, including liquidity coverage ratio, loan-to-deposit ratio, concentration limits on customer deposits, interbank borrowing utilization ratio, etc. for effective identification and control of liquidity risk. The Bank utilizes relevant management information systems to perform daily liquidity risk management functions. Moreover, the Bank performs daily cash flow analysis to assess liquidity in normal circumstances, and performs regular stress test (at least monthly) to evaluate the Bank'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 Bank'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.

The Bank has set up early warning indicator system, and movement of relevant indicators are closely monitored on a regular basis. In case of liquidity crisis emerges, the Bank's Crisis Management Committee will be formed to formulate appropriate contingency funding plan to resolve the crisis. The Bank 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 Bank 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.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk *(continued)*

3.3.3 Non-derivative financial instruments cash flows

The table below presents the cash flows of the Bank 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 Bank'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	Total
As at 31 December 2020							
Financial liabilities							
Due to banks and other financial institutions	12,549,599	6,747,437	32,924,190	17,503,877	–	2,010,294	71,735,397
Due to customers	78,937,565	69,209,537	71,214,798	26,914,263	2,500	21	246,278,684
Lease liabilities	–	14,372	28,742	84,203	113,361	1,721	242,399
Other financial liabilities	16,042	4,815,564	159,398	111,884	11	8,280	5,111,179
Total financial liabilities	91,503,206	80,786,910	104,327,128	44,614,227	115,872	2,020,316	323,367,659
	On Demand	Up to 1 month	1 – 3 months	3 – 12 months	1 – 5 years	Over 5 years	Total
As at 31 December 2019							
Financial liabilities							
Due to banks and other financial institutions	893,526	4,257,386	20,159,183	1,577,260	–	2,018,313	28,905,668
Due to customers	56,976,420	49,419,265	48,129,887	16,358,893	1,838	–	170,886,303
Lease liabilities	–	15,636	30,107	106,029	155,011	1,049	307,832
Other financial liabilities	8,442	3,915,441	323,103	101,489	7	14,730	4,363,212
Total financial liabilities	57,878,388	57,607,728	68,642,280	18,143,671	156,856	2,034,092	204,463,015

Notes to the Financial Statements

For the year ended 31 December 2020
(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 Bank's derivative financial instruments are either settled on a net basis or a gross basis.

The Bank'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 Bank 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 2020						
Derivative financial instruments settled on net basis	30,268	55,214	(318,009)	(1,367,488)	(12,866)	(1,612,881)
Derivative financial instruments settled on a gross basis						
– Outflow	(165,951,075)	(60,324,731)	(31,154,342)	–	–	(257,430,148)
– Inflow	165,743,198	60,313,467	31,100,879	–	–	257,157,544
Total	(207,877)	(11,264)	(53,463)	–	–	(272,604)
	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
As at 31 December 2019						
Derivative financial instruments settled on net basis	7,410	40,421	27,381	(203,949)	(3,403)	(132,140)
Derivative financial instruments settled on a gross basis						
– Outflow	(126,233,759)	(33,134,641)	(36,720,407)	(1,556,264)	–	(197,645,071)
– Inflow	126,244,425	32,992,658	36,771,837	1,560,239	–	197,569,159
Total	10,666	(141,983)	51,430	3,975	–	(75,912)

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

3 FINANCIAL RISK MANAGEMENT *(continued)*

3.3 Liquidity risk *(continued)*

3.3.5 Maturity analysis

The table below analyses the Bank'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 2020									
Assets									
Cash and balances with central banks	8,438,950	-	-	-	-	-	-	-	8,438,950
Due from banks and other financial institutions	15,771,749	-	927,674	1,952,969	1,442,344	-	-	-	20,094,736
Financial assets at fair value through profit or loss	-	518,037	93,487	94,489	49,329	150,091	-	-	905,433
Financial assets at fair value through other comprehensive income	-	4,804,379	4,604,924	29,689,445	122,396,089	40,443,289	-	9,697	201,947,823
Loans and advances to customers	2,413,563	811,592	2,116,258	17,235,072	67,643,350	47,073,030	221,805	-	137,514,670
Other financial assets	16,154	2,353,589	69,252	75,717	729,609	393,791	11,974	-	3,650,086
Total financial assets	26,640,416	8,487,597	7,811,595	49,047,692	192,260,721	88,060,201	233,779	9,697	372,551,698
Liabilities									
Due to banks and other financial institutions	12,549,599	6,744,481	32,892,562	17,473,034	-	2,000,000	-	-	71,659,676
Due to customers	78,921,524	69,058,751	71,038,353	26,728,791	2,490	-	-	-	245,749,909
Financial liabilities at fair value through profit or loss	-	741,434	94,386	154,879	882,007	911,279	-	-	2,783,985
Lease liabilities	-	14,086	28,230	82,565	111,740	1,712	-	-	238,333
Other financial liabilities	40,010	4,815,564	159,398	111,884	11	8,280	-	-	5,135,147
Total financial liabilities	91,511,133	81,374,316	104,212,929	44,551,153	996,248	2,921,271	-	-	325,567,050
Net amount on liquidity gap	(64,870,717)	(72,886,719)	(96,401,334)	4,496,539	191,264,473	85,138,930	233,779	9,697	46,984,648

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

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 2019									
Assets									
Cash and balances with central banks	1,094,956	–	–	–	–	–	–	–	1,094,956
Due from banks and other financial institutions	2,600,646	2,338,993	–	–	12,728,269	–	–	–	17,667,908
Financial assets at fair value through profit or loss	–	484,743	217,857	260,203	24,778	77,345	–	–	1,064,926
Financial assets at fair value through other comprehensive income	–	2,877,750	8,531,613	18,113,310	79,026,583	13,683,052	–	9,965	122,242,273
Loans and advances to customers	2,408,975	452,250	2,440,628	6,375,084	28,787,124	38,507,967	229,587	–	79,201,615
Other financial assets	2,902	4,724,076	22,694	39,626	449,284	170,039	9,751	–	5,418,372
Total financial assets	6,107,479	10,877,812	11,212,792	24,788,223	121,016,038	52,438,403	239,338	9,965	226,690,050
Liabilities									
Due to banks and other financial institutions	893,526	4,226,235	20,060,545	1,556,264	–	2,000,000	–	–	28,736,570
Due to customers	56,976,420	49,405,406	48,076,879	16,294,765	1,819	–	–	–	170,755,289
Financial liabilities at fair value through profit or loss	–	525,672	215,192	211,890	121,987	94,057	–	–	1,168,798
Lease liabilities	–	15,241	29,375	103,545	152,287	1,040	–	–	301,488
Other financial liabilities	11,917	3,915,441	323,103	112,885	7	14,730	–	–	4,378,083
Total financial liabilities	57,881,863	58,087,995	68,705,094	18,279,349	276,100	2,109,827	–	–	205,340,228
Net amount on liquidity gap	(51,774,384)	(47,210,183)	(57,492,302)	6,508,874	120,739,938	50,328,576	239,338	9,965	21,349,822

Notes to the Financial Statements

For the year ended 31 December 2020
(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 Bank 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 2020					
Loan commitments and credit related commitments	6,082,947	5,416,312	1,367,960	2,280,846	15,148,065
Guarantees, acceptances and letters of credit	292,148	27,650	2,905	5,322	328,025
Total	6,375,095	5,443,962	1,370,865	2,286,168	15,476,090
	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total
As at 31 December 2019					
Loan commitments and credit related commitments	7,103,107	1,980,552	155,847	2,356,918	11,596,424
Guarantees, acceptances and letters of credit	126,844	61,973	1,914	2,906	193,637
Total	7,229,951	2,042,525	157,761	2,359,824	11,790,061

3.4 Fair value of financial assets and liabilities

(a) Determination of fair value and valuation techniques

Certain financial assets and liabilities of the Bank 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 Bank 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 2020
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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 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 2020				
Financial assets at fair value through profit or loss				
Derivative financial instruments				
– Foreign exchange contracts	–	705,726	–	705,726
– Interest rate contracts and others	–	199,707	–	199,707
	–	905,433	–	905,433
Financial assets at fair value through other comprehensive income				
Debt securities				
– Governments and central banks	26,521,450	860,630	–	27,382,080
– Banks and other financial institutions	101,091,487	19,476,813	–	120,568,300
– Corporate entities	53,580,340	407,406	–	53,987,746
Equity securities				
– Banks and other financial institutions	–	–	9,697	9,697
	181,193,277	20,744,849	9,697	201,947,823
Total financial assets measured at fair value	181,193,277	21,650,282	9,697	202,853,256
Financial liabilities at fair value through profit or loss				
Derivative financial instruments				
– Foreign exchange contracts	–	982,850	–	982,850
– Interest rate contracts and others	–	1,801,135	–	1,801,135
Total financial liabilities measured at fair value	–	2,783,985	–	2,783,985

Notes to the Financial Statements

For the year ended 31 December 2020
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3 FINANCIAL RISK MANAGEMENT *(continued)*

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

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

	Level 1	Level 2	Level 3	Total
As at 31 December 2019				
Financial assets at fair value through profit or loss				
Debt securities				
– Governments and central banks	189,962	–	–	189,962
Derivative financial instruments				
– Foreign exchange contracts	–	773,118	–	773,118
– Interest rate contracts and others	–	101,846	–	101,846
	189,962	874,964	–	1,064,926
Financial assets at fair value through other comprehensive income				
Debt securities				
– Governments and central banks	22,084,902	–	–	22,084,902
– Banks and other financial institutions	65,751,353	16,149,042	–	81,900,395
– Corporate entities	18,247,011	–	–	18,247,011
Equity securities				
– Banks and other financial institutions	–	–	9,965	9,965
	106,083,266	16,149,042	9,965	122,242,273
Total financial assets measured at fair value	106,273,228	17,024,006	9,965	123,307,199
Financial liabilities at fair value through profit or loss				
Derivative financial instruments				
– Foreign exchange contracts	–	951,285	–	951,285
– Interest rate contracts and others	–	217,513	–	217,513
Total financial liabilities measured at fair value	–	1,168,798	–	1,168,798

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

Notes to the Financial Statements

For the year ended 31 December 2020
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3 FINANCIAL RISK MANAGEMENT *(continued)*

3.5 Offsetting financial assets and financial liabilities

Certain financial assets and financial liabilities of the Bank are subject to enforceable master netting arrangements or similar agreements. The agreement between the Bank 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 Bank 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 2020 and 31 December 2019. The column 'net amount' shows the impact on the Bank'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	
2020						
Financial assets						
Derivative financial instruments	905,433	–	905,433	(725,558)	(118,302)	61,573
Financial assets at fair value through other comprehensive income	29,069,588	–	29,069,588	(26,921,033)	–	2,148,555
Total	29,975,021	–	29,975,021	(27,646,591)	(118,302)	2,210,128
	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	
2020						
Financial liabilities						
Derivative financial instruments	2,783,985	–	2,783,985	(725,558)	(268,390)	1,790,037
Due to banks and other financial institutions	26,921,033	–	26,921,033	(26,921,033)	–	–
Total	29,705,018	–	29,705,018	(27,646,591)	(268,390)	1,790,037

Notes to the Financial Statements

For the year ended 31 December 2020
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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	Gross amounts of recognized financial assets 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	
2019							
Financial assets							
Derivative financial instruments	874,964	–	–	874,964	(696,273)	(2,093)	176,598
Financial assets at fair value through other comprehensive income	11,067,402	–	–	11,067,402	(10,459,812)	–	607,590
Total	11,942,366	–	–	11,942,366	(11,156,085)	(2,093)	784,188

	Gross amounts of recognized financial liabilities	Gross amounts of recognized financial assets set off in the statement of financial position	Gross amounts of recognized financial liabilities 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	
2019							
Financial liabilities							
Derivative financial instruments	1,168,798	–	–	1,168,798	(696,273)	(217,465)	255,060
Due to banks and other financial institutions	10,459,812	–	–	10,459,812	(10,459,812)	–	–
Total	11,628,610	–	–	11,628,610	(11,156,085)	(217,465)	255,060

3.6 Capital management

The Bank'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 Bank operates;
- To ensure the Bank'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 Bank monitors its capital structure on the basis of the capital adequacy ratio and there have been no material changes in the Bank's policy on the management of capital during the year.

The Bank has complied with all externally imposed capital requirements during 2020.

Notes to the Financial Statements

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4 NET INTEREST INCOME

	2020	2019
Interest income		
Due from banks and other financial institutions	338,956	408,951
Loans and advances to customers	2,117,419	2,135,929
Financial assets at fair value through other comprehensive income	2,868,572	3,531,136
	5,324,947	6,076,016
Interest expense		
Due to banks and other financial institutions	(442,626)	(560,225)
Due to customers	(2,604,181)	(2,594,622)
	(3,046,807)	(3,154,847)
Net interest income	2,278,140	2,921,169

5 FEE AND COMMISSION INCOME

	2020	2019
Settlement service	41,026	46,684
Interchange service	22,617	38,575
Credit facilities, guarantee and commitment	2,905	2,589
Agency service	682,328	592,260
Depository service	61,043	61,752
Others	4,927	4,763
	814,846	746,623
Of which arise from:		
Financial assets/liabilities not at fair value through profit or loss	2,905	2,589
Trust and other fiduciary activities	88,074	83,402

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6 FEE AND COMMISSION EXPENSE

	2020	2019
Settlement and brokerage service	34,796	38,503
Interchange service	10,121	9,870
Others	11,717	8,163
	56,634	56,536
Of which arise from:		
Financial assets/liabilities not at fair value through profit or loss	10,121	9,870

7 DIVIDEND INCOME

	2020	2019
Financial assets at fair value through other comprehensive income – unlisted investments	35	35

8 NET GAINS ARISING FROM TRADING ACTIVITIES

	2020	2019
Foreign exchange	565,379	37,585
Interest rate instruments and others	10,740	(163)
Debt securities at fair value through profit or loss	32,564	44,278
Net losses of interest rate instruments and items under fair value hedge	(63,693)	(5,287)
	544,990	76,413

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.

9 OTHER OPERATING INCOME

	2020	2019
Management fee received from a branch of the ultimate holding company (Note 34 (g))	3,490	6,565
Others	11,590	14,976
	15,080	21,541

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

Notes to the Financial Statements

For the year ended 31 December 2020
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10 CHANGE IN EXPECTED CREDIT LOSSES (“ECL”)

	2020	2019
Change in ECL allowance		
Loans and advances to customers		
– new charges	474,407	126,463
– recoveries	(212,829)	(34,226)
	261,578	92,237
Financial investments	197,631	60,242
Cash and balances with central bank	15	–
Other receivables	2,180	1,354
Due from banks and other financial institutions	(178)	2,224
Financial guarantees and credit related commitments	9,098	3,931
	208,746	67,751
	470,324	159,988

11 OTHER OPERATING EXPENSES

	2020	2019
Staff costs		
– salaries and other allowances	473,136	512,954
– retirement benefit costs (Note 12)	35,944	34,261
Loss on disposal of property and equipment	–	25
General operational and administrative expenses	231,573	260,597
Depreciation and amortization	24,420	30,365
Depreciation of right-of-use assets (Note 23)	177,833	166,890
Auditor’s remuneration	5,931	4,200
Buildings administration fee	9,634	10,113
Rental expenses	32,925	45,645
Repairs and maintenance	31,389	44,162
Printing, postage and telegram	49,675	51,133
Withholding tax	144	–
Directors’, senior management’s and key personnel’s emoluments (Note 13)	18,992	18,715
Management fee paid to a branch of the ultimate holding company	418,296	344,728
Finance costs – lease interest expense (Note 23)	4,699	4,820
Others	29,512	17,619
	1,544,103	1,546,227

Notes to the Financial Statements

For the year ended 31 December 2020
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12 RETIREMENT BENEFIT COSTS

	2020	2019
Pension costs – defined contribution plans	35,944	34,261

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 Bank in respect of their services rendered for the Bank are as follows:

	2020	2019
Directors' fees	2,473	1,397
Salaries, allowances and benefits in kind	–	180
Bonuses	–	1,176
Retirement benefit costs	–	3
	2,473	2,756

For the year ended 31 December 2020 and 2019, some of the executive directors received emoluments and emoluments receivable from HKBR, amounting to HK\$14,227,000 (2019: HK\$13,834,000), in respect of their service to the Bank and HKBR. The portion of the directors' emoluments in relation to the services to the Bank of HK\$9,207,000 (2019: HK\$8,980,000) has been borne 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 Bank's business to which the Bank was a party and in which a director of the Bank 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

For the year ended 31 December 2020
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14 INCOME TAX EXPENSES

	2020	2019
Current tax		
– Hong Kong profits tax	339,685	390,780
– Overprovision in prior years	(909)	(7,930)
	338,776	382,850
Deferred income tax (Note 22)	(41,209)	(16,690)
Income tax expense	297,567	366,160

The current tax provision for the year ended 31 December 2020 and 2019 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:

	2020	2019 (restated)
Profit before tax	1,747,936	2,428,834
Tax calculated at a tax rate of 16.5%	288,409	400,758
Tax effect of expense not deductible for tax purpose	32,609	9,940
Tax effect arising from income not subject to tax	(22,417)	(35,332)
Overprovision in prior years	(909)	(7,930)
Others	(125)	(1,276)
	297,567	366,160

15 CASH AND BALANCES WITH CENTRAL BANK

	2020	2019
Cash	1,824,960	440,753
Balances with central bank	6,614,005	654,203
Less: ECL allowances	(15)	–
	8,438,950	1,094,956

Notes to the Financial Statements

For the year ended 31 December 2020
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16 DUE FROM BANKS AND OTHER FINANCIAL INSTITUTIONS

	2020	2019
Due from banks and other financial institutions	15,771,766	2,600,649
Placements with and loans to banks	4,331,101	15,075,568
Less: ECL allowances	(8,131)	(8,309)
	20,094,736	17,667,908

17 FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

	2020	2019
Derivative financial instruments (Note 18)	905,433	874,964
Debt securities at fair value through profit or loss		
Government bonds		
– Listed outside Hong Kong	–	34,484
– Unlisted	–	155,478
	905,433	1,064,926

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

	2020	2019
Debt securities at fair value through profit or loss		
– Governments and central banks	–	189,962

Notes to the Financial Statements

For the year ended 31 December 2020

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18 DERIVATIVE FINANCIAL INSTRUMENTS

The following derivative instruments are utilized by the Bank 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 Bank'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 Bank 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 Bank 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 Bank'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 2020
(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 2020									
Foreign exchange contracts	-	-	-	256,886,730	705,726	(982,850)	256,886,730	705,726	(982,850)
Interest rate contracts and others	85,590,304	156,020	(1,768,972)	4,541,625	43,687	(32,163)	90,131,929	199,707	(1,801,135)
Total amount of derivative instruments recognized	85,590,304	156,020	(1,768,972)	261,428,355	749,413	(1,015,013)	347,018,659	905,433	(2,783,985)
As at 31 December 2019									
Foreign exchange contracts	-	-	-	197,148,441	773,118	(951,285)	197,148,441	773,118	(951,285)
Interest rate contracts and others	25,129,426	96,572	(211,910)	749,341	5,274	(5,603)	25,878,767	101,846	(217,513)
Total amount of derivative instruments recognized	25,129,426	96,572	(211,910)	197,897,782	778,392	(956,888)	223,027,208	874,964	(1,168,798)

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

The Bank 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:

	2020	2019
Renminbi	17,892,359	42,237,988
United States Dollar	175,000,219	107,842,171
Hong Kong Dollar	143,601,025	67,861,606
Others	10,525,056	5,085,443
Total	347,018,659	223,027,208

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18 DERIVATIVE FINANCIAL INSTRUMENTS *(continued)*

Hedge accounting

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

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

The Bank holds a portfolio of long-term fixed rate debt securities and loans and therefore is exposed to changes in fair value due to movements in market rates. The Bank 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 Bank. 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 Bank 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 Bank 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.
- a) The following table sets out the maturity profile and average interest rate of the hedging instruments used in the Bank's hedging strategies:

As at 31 December 2020	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 amount	403,127	785,323	1,196,589	51,893,754	31,311,511	85,590,304
Average fixed interest rate	2.42%	3.5%	3.10%	3.37%	3.33%	3.35%
	Maturity					Total
As at 31 December 2019	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 amount	–	1,089,385	427,973	14,014,934	9,597,134	25,129,426
Average fixed interest rate	–	2.38%	2.64%	3.74%	3.92%	3.65%

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For the year ended 31 December 2020
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18 DERIVATIVE FINANCIAL INSTRUMENTS *(continued)*

Hedge accounting *(continued)*

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

As at 31 December 2020	Carrying amount			Line item on statement of financial position	Fair value changes of the hedging instruments
	Notional amount	Assets	Liabilities		
Fair value hedge					
Interest rate					
Interest rate contract	85,590,304	156,020	(1,768,972)	Financial assets/ liabilities at fair value through profit or loss	(1,522,803)

As at 31 December 2019	Carrying amount			Line item on statement of financial position	Fair value changes of the hedging instruments
	Notional amount	Assets	Liabilities		
Fair value hedge					
Interest rate					
Interest rate contract	25,129,426	96,572	(211,910)	Financial assets/ liabilities at fair value through profit or loss	(97,377)

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For the year ended 31 December 2020
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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 Bank's hedging strategies:

As at 31 December 2020	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	85,629,923	1,421,159	Financial asset at fair value through other comprehensive income	1,340,771	(64,653)
Loans and advances to customers	1,708,267	149,773	Loans and advances to customers	118,339	960
As at 31 December 2019	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	23,691,106	84,439	Financial asset at fair value through other comprehensive income	60,656	(6,004)
Loans and advances to customers	1,589,928	31,434	Loans and advances to customers	31,434	717

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18 DERIVATIVE FINANCIAL INSTRUMENTS *(continued)*

Hedge accounting *(continued)*

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

For the year ended 31 December 2020	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	–	(63,693)	Net gains arising from trading activities
	Gains/(losses) recognized in other comprehensive Income	Hedge ineffectiveness recognized in profit and loss	Profit and loss line item that includes hedge ineffectiveness
For the year ended 31 December 2019			
Fair value hedge			
Interest rate	–	(5,287)	Net gains arising from trading activities

Notes to the Financial Statements

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19 LOANS AND ADVANCES TO CUSTOMERS

19.1 Loans and advances to customers

	2020	2019
Loans and advances to customers	138,089,467	79,519,025
Less: ECL allowance	(574,797)	(317,410)
	137,514,670	79,201,615

19.2 Analysis of loans and advances to customers by staging

As at 31 December 2020	Stage 1 allowance	Stage 2 allowance	Stage 3 allowance	Total
Gross loans and advances (Note)	135,580,432	2,403,153	105,882	138,089,467
ECL allowance	(381,199)	(149,365)	(44,233)	(574,797)
Net loans and advances to customers	135,199,233	2,253,788	61,649	137,514,670

Note: Included in the stage 1 balance is a fair value change of hedging adjustment of HK\$149,773,000 which is not subject to ECL allowance.

As at 31 December 2019	Stage 1 allowance	Stage 2 allowance	Stage 3 allowance	Total
Gross loans and advances (Note)	78,885,497	571,140	62,388	79,519,025
ECL allowance	(228,363)	(60,402)	(28,645)	(317,410)
Net loans and advances to customers	78,657,134	510,738	33,743	79,201,615

Note: Included in the stage 1 balance is a fair value change of hedging adjustment of HK\$31,434,000 which is not subject to ECL allowance.

19.3 Credit quality of loans and advances to customers

Loans and advances to customers analyzed by security type

	2020	2019
Unsecured loans	36,512,184	22,323,157
Loans secured by guarantee	40,947,786	15,092,813
Collateralized and other secured loans	60,629,497	42,103,055
Gross amount of loans and advances to customers before ECL allowance	138,089,467	79,519,025

Notes to the Financial Statements

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19 LOANS AND ADVANCES TO CUSTOMERS *(continued)*

19.4 Overdue loans

Gross advances to customers overdue for more than 3 months

	2020		2019	
		% of gross advances to customers		% of gross advances to customers
Six months or less but over three months	27,852	0.02%	28,486	0.04%
One year or less but over six months	25,675	0.02%	3,073	0.00%
Over one year	46,558	0.03%	15,359	0.02%
Total gross amount of advances overdue for more than three months	100,085	0.07%	46,918	0.06%
ECL allowance for stage 3	43,292		26,689	
Rescheduled advances excluding those overdue for more than three months	800	0.00%	1,271	0.00%

20 FINANCIAL ASSETS AT FAIR VALUE THROUGH COMPREHENSIVE INCOME

	2020	2019
Debt securities at fair value through other comprehensive income		
– Listed	93,603,225	56,023,727
– Unlisted	108,334,901	66,208,581
Equity securities designated at fair value through other comprehensive income		
– Unlisted	9,697	9,965
	201,947,823	122,242,273

The Bank has designated the investment in equity instrument issued by Joint Electronic Teller Services Limited at fair value through other comprehensive income. The Bank 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.

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20 FINANCIAL ASSETS AT FAIR VALUE THROUGH COMPREHENSIVE INCOME *(continued)*

The fair value of this investment is HK\$9,697,000 as at 31 December 2020 (31 December, 2019: HK\$9,965,000) and a dividend of HK\$35,000 (31 December, 2019: HK\$35,000) was recognized for the year. There is no transfer of the cumulative loss within equity.

Financial investments analyzed by issuer are as follows:

	2020	2019
Debt securities at fair value through other comprehensive income		
– Governments and central banks	27,382,080	22,084,902
– Banks and other financial institutions	120,568,300	81,900,395
– Corporate entities	53,987,746	18,247,011
Equity securities at fair value through other comprehensive income		
– Banks and other financial institutions	9,697	9,965
	201,947,823	122,242,273

21 PROPERTY AND EQUIPMENT

	Equipment	Property improvement	Total
Cost			
As at 1 January 2020	60,400	44,260	104,660
Additions	13,036	10,443	23,479
As at 31 December 2020	73,436	54,703	128,139
Accumulated depreciation			
As at 1 January 2020	(29,847)	(21,337)	(51,184)
Charge for the year	(10,962)	(10,201)	(21,163)
As at 31 December 2020	(40,809)	(31,538)	(72,347)
Net book value			
As at 31 December 2020	32,627	23,165	55,792

Notes to the Financial Statements

For the year ended 31 December 2020
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21 PROPERTY AND EQUIPMENT *(continued)*

	Equipment	Property improvement	Total
Cost			
As at 1 January 2019	61,892	83,417	145,309
Additions	11,758	3,279	15,037
Disposal	(13,250)	(42,436)	(55,686)
As at 31 December 2019	60,400	44,260	104,660
Accumulated depreciation			
As at 1 January 2019	(31,000)	(46,891)	(77,891)
Charge for the year	(12,072)	(16,882)	(28,954)
Disposal	13,225	42,436	55,661
As at 31 December 2019	(29,847)	(21,337)	(51,184)
Net book value			
As at 31 December 2019	30,553	22,923	53,476

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22 DEFERRED INCOME TAX ASSETS/(LIABILITIES)

The movements on the net deferred tax assets/(liabilities) are as follows:

	2020	2019
As at 1 January	(46,906)	10,978
Deferred income tax credited to income statement (Note 14)	41,209	16,690
Deferred income tax debited to equity	(157,803)	(74,574)
As at 31 December	(163,500)	(46,906)

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

	2020	2019
Deferred tax assets		
ECL allowances	93,579	52,042
Deferred tax liabilities		
Accelerated depreciation allowances	(7,875)	(7,547)
Revaluation of investment securities	(249,204)	(91,401)
	(163,500)	(46,906)

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:

	2020	2019
Deferred tax assets	93,579	52,042
Deferred tax liabilities	(257,079)	(98,948)
	(163,500)	(46,906)

Notes to the Financial Statements

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23 RIGHT-OF-USE ASSETS

	2020
Gross:	
As at 1 January 2020	465,109
Additions	113,863
Reductions	(824)
As at 31 December 2020	578,148
Accumulated depreciation	
As at 1 January 2020	(166,700)
Charge for the year (Note 11)	(177,833)
Reduction	515
As at 31 December 2020	(344,018)
Net book value	
As at 1 January 2020	298,409
As at 31 December 2020	234,130
	2019
Gross:	
As at 1 January 2019	203,642
Additions	263,936
Reductions	(2,469)
As at 31 December 2019	465,109
Accumulated depreciation	
As at 1 January 2019	–
Charge for the year (Note 11)	(166,890)
Reduction	190
As at 31 December 2019	(166,700)
Net book value	
As at 1 January 2019	203,642
As at 31 December 2019	298,409

Notes to the Financial Statements

For the year ended 31 December 2020
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23 RIGHT-OF-USE ASSETS *(continued)*

(i) Amounts recognized in the statement of financial position

The statement of financial position shows the following amounts relating to leases:

Right-of-use asset	2020	2019
Properties	230,001	289,945
Equipment	3,867	8,328
Others	262	136
	234,130	298,409
Lease liabilities	238,333	301,488

(ii) Amounts recognized in the statement of profit or loss

The statement of profit or loss shows the following amounts relating to leases:

Depreciation charge of right-of-use assets (Note 11)	2020	2019
Properties	171,047	159,967
Equipment	6,666	6,870
Others	120	53
	177,833	166,890

The statement of profit or loss shows the following amounts relating to leases:

Finance costs-lease interest expense (Note 11)	2020	2019 (restated)
Properties	4,597	4,663
Equipment	97	156
Others	5	1
	4,699	4,820

The total cash outflow for leases in 2020 was HK\$209,630,000 (2019:HK\$193,453,000).

(iii) The Bank's leasing activities and how these are accounted for

The Bank leases various retail stores, equipment and advertising spaces. Rental contracts are typically made for fixed periods of 1 year to 8 years, but may have extension options as described in (iv) below.

Lease terms are negotiated on an individual basis and contain a wide range of different terms and conditions. The lease agreements do not impose any covenants but leased assets may not be used as security for borrowing purposes.

(iv) Extension and termination options

Extension and termination options are included in a number of retail stores across the Bank. These terms are used to maximise operational flexibility in terms of managing contracts. The majority of extension and termination options held are exercisable only by the Bank and not by the respective lessor.

Notes to the Financial Statements

For the year ended 31 December 2020
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24 OTHER ASSETS

	2020	2019
Interest receivable	1,627,855	839,730
Settlement accounts	2,015,500	4,563,044
Other receivables, prepayments and others	77,398	89,960
Less: ECL allowances	(18,055)	(15,495)
Intangible assets (a)	19,320	12,198
	3,722,018	5,489,437

(a) Intangible assets

	Software
Cost	
As at 1 January 2020	13,637
Additions	10,379
As at 31 December 2020	24,016
Accumulated amortization	
As at 1 January 2020	(1,439)
Amortization expenses	(3,257)
As at 31 December 2020	(4,696)
Net book value as at 31 December 2020	19,320
Cost	
As at 1 January 2019	1,523
Additions	12,114
As at 31 December 2019	13,637
Accumulated amortization	
As at 1 January 2019	(28)
Amortization expenses	(1,411)
As at 31 December 2019	(1,439)
Net book value as at 31 December 2019	12,198

Notes to the Financial Statements

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25 DUE TO BANKS AND OTHER FINANCIAL INSTITUTIONS

	2020	2019
Deposits from banks and other financial institutions	42,738,643	16,276,758
Subordinated loan from the ultimate holding company	2,000,000	2,000,000
Financial assets sold under repurchase agreements (Note 33)	26,921,033	10,459,812
Total	71,659,676	28,736,570

26 DUE TO CUSTOMERS

	2020	2019
Demand deposits and current accounts	11,312,443	7,904,693
Saving deposits	67,609,080	49,071,727
Time, call, notice and other deposits	166,828,386	113,778,869
	245,749,909	170,755,289
Including:		
Deposits pledged as collateral	3,113,674	2,240,493

27 FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT OR LOSS

	2020	2019
Derivative financial instruments (Note 18)	2,783,985	1,168,798

For the year ended 31 December 2020 and 2019, there were no significant changes in the fair value of the Bank's financial liabilities designated as at fair value through profit or loss that were attributable to the changes in credit risk.

28 OTHER LIABILITIES

	2020	2019
Interest payable	440,341	727,400
Settlement accounts	1,908,546	2,471,380
Withholding tax	61,840	58,064
Provision for impairment allowances on financial guarantees and credit related commitment	23,970	14,872
Others	2,816,599	1,211,293
Total	5,251,296	4,483,009

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

29 SHARE CAPITAL

	Number of shares	Share capital
As at 31 December 2019	17,900,000,000	17,900,000
As at 31 December 2020	37,900,000,000	37,900,000

The Bank issued 20,000,000,000 ordinary shares to its ultimate holding company, Bank of Communications Co. Ltd on 21 September 2020.

30 ADDITIONAL EQUITY INSTRUMENT

	2020	2019
Undated non-cumulative subordinated Additional Tier 1 capital securities with US\$500 million	3,871,450	–

In March 2020, the Bank issued USD500 million undated non-cumulative subordinated Additional Tier 1 capital securities. The capital securities are perpetual securities and listed on the Stock Exchange of Hong Kong Limited in respect of which they may be redeemed at the Bank's option on 3 March 2025 and every six months thereafter or the occurrence of certain other events. They have an initial rate of distribution of 3.725% per annum payable semi-annually in arrear in year 1 to year 5 and resettable on year 5 and every 5 years thereafter at then prevailing 5-year U.S. Treasury yield plus 2.525% per annum. The Bank has paid dividend of HKD72,169,000 to the additional equity instrument holders for the year ended 31 December 2020 (31 December 2019:Nil).

Notes to the Financial Statements

For the year ended 31 December 2020
(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 Bank's financial guarantees and credit related commitments which the Bank has committed to its customers:

	2020	2019
Letters of guarantee	39,106	41,215
Letters of credit commitments	206,580	138,802
Acceptances bills	82,339	13,620
Credit card commitments	5,337,565	6,034,752
Other credit-related commitments		
Under 1 year	6,161,693	3,048,907
More than 1 year	3,648,807	2,512,765
	15,476,090	11,790,061

Capital expenditure commitments

	2020	2019
Contracted but not provided for	13,583	7,710

Operating lease commitments

As at 31 December 2020 and 2019, the Bank has no non-cancellable operating lease commitments related to short-term leases, which are the leases with a lease term of 12 months or less.

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:

	2020	2019
Cash and balances with central bank (Note 15)	8,438,950	1,094,956
Due from banks and other financial institutions	15,771,766	4,939,639
	24,210,716	6,034,595

Notes to the Financial Statements

For the year ended 31 December 2020
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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 Bank 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 Bank is still exposed to substantially all the credit risks and market risks and rewards of those securities sold. These securities, which the Bank 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 Bank retains substantially all the risks and rewards of these securities. In addition, it recognizes a financial liability for cash received.

As at 31 December 2020 and 2019, the Bank entered into repurchase agreements with certain counterparties. The proceeds from selling such securities were presented as "financial assets sold under repurchase agreements" (see Note 25).

	Transferred assets		Associated liabilities	
	2020	2019	2020	2019
Investment securities	29,069,588	11,067,402	(26,921,033)	(10,459,812)

34 MATERIAL RELATED PARTY TRANSACTIONS

(a) Parent entity

The Bank is controlled by the following entity:

Name	Type	Place of incorporation	Ownership interest	
			2020	2019
Bank of Communications Co., Ltd	Ultimate parent entity and controlling party	People's Republic of China	100%	100%

(b) Key management personnel compensation

	2020	2019
	Short-term employee benefits	15,161
Post-employment benefits	1,358	1,179
	16,519	15,959

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

34 MATERIAL RELATED PARTY TRANSACTIONS *(continued)*

(c) Transactions with the Ministry of Finance of the People's Republic of China ("MOF")

As at 31 December 2020, the MOF holds 17,732 million (31 December 2019: 17,732 million) shares of the ultimate holding company of the Bank which represents 23.88% (31 December 2019: 23.88%) of equity interest of the ultimate holding company of the Bank.

The MOF is a Chinese government ministry, primarily responsible for managing state fiscal revenue and expenditures, and establishing and enforcing taxation policies. The Bank 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:

	2020	2019
Bonds issued by MOF	11,189,106	5,263,457
Other assets	9,650	16,737
Interest income	131,770	141,272
Net gains arising from trading activities	5,674	–

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

As at 31 December 2020, HSBC holds 13,886 million (31 December 2019: 13,886 million) shares of the ultimate holding company of the Bank which represents 18.7% (31 December 2019: 18.70%) of total share capital of the Bank. Transactions between the Bank and HSBC are carried out under normal commercial terms and paid at market rates.

Details of transactions and outstanding balances are summarized below:

	2020	2019
Due from banks and other financial institutions	724,356	3,852
Financial assets at fair value through other comprehensive income	1,545,394	1,455,631
Derivative financial assets	63,620	97,336
Other assets	344	9,677
Due to banks and other financial institutions	6,426,055	17,643
Derivative financial liabilities	50,848	165,107
Other liabilities	5,492	–
Interest income	26,118	39,418
Interest expense	834	78
Net(losses)/gains arising from trading activities	(246,566)	201,031
Net gains arising from financial investments	13,507	2,497

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

34 MATERIAL RELATED PARTY TRANSACTIONS *(continued)*

(e) Transactions with fellow subsidiaries

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

Details of transactions and outstanding balances are summarized below:

	2020	2019
Loans and advances to customers	428,632	433,679
Other assets	627	173
Due to customers	433,338	471,755
Other liabilities	8,570	10,517
Fee and commission income	13,057	12,578
Interest income	12,742	15,698
Interest expense	274	618
Fee and commission expense	16,266	13,623
Rental expenses	28,286	26,522
Other operating expenses	33,323	31,204

(f) Transactions with directors and senior management

	2020	2019
Loans and advances to customers	1,307	324
Due to customers	80,582	46,804
Interest income	3	3
Interest expense	778	294

Particular of loans made to directors of the Bank 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 2020 and 2019 are as follows:

	2020	2019
Aggregate amount of relevant transactions outstanding at year end	304	47
Maximum aggregate amount of relevant transactions outstanding during the year	440	386

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

34 MATERIAL RELATED PARTY TRANSACTIONS *(continued)*

(g) Transactions with the ultimate holding company

Transactions between the Bank 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:

	2020	2019 (restated)
Due from banks and other financial institutions	12,773,122	11,548,722
Other assets	389,125	291,934
Derivative financial assets	509,310	602,306
Due to banks and other financial institutions	28,358,299	17,659,827
Other liabilities	789,875	470,543
Derivative financial liabilities	1,909,162	475,004
Interest income	131,904	280,609
Interest expense	207,908	357,593
Other operating expenses	484,744	409,833
Other operating income	3,490	6,565
Purchase of debt securities	1,975,017	51,737,488
Disposal of debt securities	843,232	20,028,592
Purchase of loans and advances	62,948,109	16,420,942
Disposal of loans and advances	–	1,020,712
Net losses arising from trading activities	1,415,204	343,520
Net gains arising from financial investments	3	282,266

35 SEGMENTAL ANALYSIS

The Bank manages the business mainly from an operating segment perspective and the majority of the Bank's revenues, profits before tax and assets are derived from Hong Kong. The Bank 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.

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

35 SEGMENTAL ANALYSIS *(continued)*

The business information of the Bank is summarized as follows:

	2020				Total
	Corporate Banking	Personal Banking	Treasury	Others	
External net interest income/(expense)	735,660	(1,172,856)	2,715,336	–	2,278,140
Inter-segment net interest income/(expense)	(208,500)	2,892,089	(2,683,589)	–	–
Net interest income	527,160	1,719,233	31,747	–	2,278,140
Net fee and commission income/(expense)	33,393	762,418	(37,599)	–	758,212
Net gains arising from trading activities	–	–	544,990	–	544,990
Net gains arising from financial investments	–	–	165,906	–	165,906
Dividend income	–	–	35	–	35
Other operating (expense)/income	(160)	14,976	10	254	15,080
Total operating income	560,393	2,496,627	705,089	254	3,762,363
Change in expected credit losses	(239,973)	(32,577)	(197,455)	(319)	(470,324)
Other operating expense					
– Depreciation and amortization	(4,782)	(191,810)	(107)	(5,554)	(202,253)
– Others	(73,690)	(760,115)	(72,161)	(435,884)	(1,341,850)
Profit/(loss) before tax	241,948	1,512,125	435,366	(441,503)	1,747,936
Income tax expense	–	–	–	(297,567)	(297,567)
Net profit/(loss) for the year	241,948	1,512,125	435,366	(739,070)	1,450,369
Depreciation and amortization	(4,782)	(191,810)	(107)	(5,554)	(202,253)
Capital expenditure	(2,395)	(21,972)	–	(9,491)	(33,858)
Segment assets	94,888,544	46,719,355	230,036,002	–	371,643,901
Unallocated assets	–	–	–	1,319,941	1,319,941
Total assets	94,888,544	46,719,355	230,036,002	1,319,941	372,963,842
Segment liabilities	(40,481,753)	(209,984,113)	(74,376,633)	–	(324,842,499)
Unallocated liabilities	–	–	–	(1,004,200)	(1,004,200)
Total liabilities	(40,481,753)	(209,984,113)	(74,376,633)	(1,004,200)	(325,846,699)

Notes to the Financial Statements

For the year ended 31 December 2020
(All amounts expressed in thousands of HK\$ unless otherwise stated)

35 SEGMENTAL ANALYSIS (continued)

	2019				
	Corporate Banking	Personal Banking	Treasury	Others	Total
External net interest income/(expense)	894,701	(1,325,869)	3,352,337	–	2,921,169
Inter-segment net interest income/(expense)	(397,424)	2,807,313	(2,409,889)	–	–
Net interest income	497,277	1,481,444	942,448	–	2,921,169
Net fee and commission income/(expense)	15,604	713,986	(39,503)	–	690,087
Net gains arising from trading activities	–	–	76,413	–	76,413
Net gains arising from financial investments	–	–	425,804	–	425,804
Dividend income	–	–	35	–	35
Other operating (expense)/income	(81)	20,818	9	795	21,541
Total operating income	512,800	2,216,248	1,405,206	795	4,135,049
Change in expected credit losses	(14,668)	(81,797)	(63,495)	(28)	(159,988)
Other operating expense					
– Depreciation and amortization	(4,903)	(188,005)	(106)	(4,241)	(197,255)
– Others	(78,264)	(792,743)	(72,517)	(405,448)	(1,348,972)
Profit/(loss) before tax	414,965	1,153,703	1,269,088	(408,922)	2,428,834
Income tax expense	–	–	–	(366,160)	(366,160)
Net profit/(loss) for the year	414,965	1,153,703	1,269,088	(775,082)	2,062,674
Depreciation and amortization	(4,903)	(188,005)	(106)	(4,241)	(197,255)
Capital expenditure	(2,683)	(22,865)	(10)	(1,593)	(27,151)
Segment assets	44,332,957	36,638,607	145,994,973	–	226,966,537
Unallocated assets	–	–	–	146,463	146,463
Total assets	44,332,957	36,638,607	145,994,973	146,463	227,113,000
Segment liabilities	(17,600,926)	(156,060,154)	(31,263,776)	–	(204,924,856)
Unallocated liabilities	–	–	–	(1,102,136)	(1,102,136)
Total liabilities	(17,600,926)	(156,060,154)	(31,263,776)	(1,102,136)	(206,026,992)

36 NON-ADJUSTING EVENT AFTER REPORTING PERIOD

Loans Portfolio transfer

Subsequent to the reporting date, the Bank expanded its loans business by acquiring certain loans portfolio approximately HK\$10 billion and HK\$4.5 billion in February 2021 and March 2021 from HKBR respectively. These loan transfer transactions entered with HKBR were conducted in the ordinary and usual course of business and on normal commercial terms.

37 COMPARATIVE FIGURES

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

Unaudited Supplementary Financial Information

For the year ended 31 December 2020

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 Bank was committed to fulfilling the responsibilities of corporate governance and continuously moved forward the establishment of the corporate governance policy and mechanism. The Bank also refined the assignment of duties and authorities of Specialized Committees under the Board of Directors (“Board”) which continuously enhance the effectiveness of corporate governance.

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

The Bank 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 (4) Specialized Committees, namely Audit Committee, Nomination Committee, Remuneration Committee and Risk Management Committee since June 2017. The Specialized Committees are responsible for reporting its work to the Board, and to assist the Board to perform their duties in accordance with authorization from the Board.

2 Board of Directors

The Board is at the core of the Bank’s corporate governance framework and has the ultimate responsibilities to the shareholder, depositors, creditors, employees, other stakeholders and banking supervisors of the Bank. 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 2020

2 Board of Directors *(continued)*

During the year, the Board had held five (5) meetings and major works performed by the Board include:

- (1) Adoption of the proposal to the Sole Shareholder of the Bank to change the Bank's status from a private company limited by shares to a public company limited by shares and amend the Bank's articles of association, effective from 6 January 2020;
- (2) Approval of the issuance of no more than US\$500 million or equivalent non-cumulate subordinated additional tier 1 capital securities;
- (3) Approval of annual financial budget and financial accounts;
- (4) Approval of a programme to issue certificates of deposit initially for an aggregate amount of HK\$30 billion or its equivalent;
- (5) Approval of the issuance of 20 billion ordinary shares;
- (6) Approval of the nomination of 1 Executive Director candidate by the Nomination Committee. 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;
- (7) 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; and
- (8) Review of the work carried out by Specialized Committees.

3 Audit Committee

The Audit Committee, established and authorized by the Board, is primarily responsible for monitoring the effectiveness of the Bank'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 Bank;
- (3) To approve the Audit Charter drawn up and updated periodically by the Audit Department of the Bank;
- (4) To approve the annual Audit Plan and the related manpower and financial resources required after identifying the areas of risk within the Bank'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 2020

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), Mr. Chan Ka Lok and Ms. Chan Ching Har Eliza.

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.

The Nomination 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. All current members of the Nomination Committee are Independent Non-executive Directors, namely Ms. Chan Ching Har Eliza (Chairman of the Nomination Committee), Mr. Chan Ka Lok and Mr. Lam Yim Nam.

Four (4) 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;
- (2) Review of the Terms of Reference of the Nomination Committee;
- (3) Review of policies related to the succession and appointment of Directors and Senior Management; and
- (4) Evaluation of the independence of the Independent Non-executive Directors, performance of the Board, its Specialized Committees and the Board members.

Unaudited Supplementary Financial Information

For the year ended 31 December 2020

5 Remuneration Committee

The main duties of the Remuneration Committee are as follows:

- (1) To make recommendations to the Board on the Bank'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, Senior Management and Key Personnel;
- (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; to lay down the Bank's ethical standards and promote them to all levels of staff; to review and approve the proposed amendment of the Code of Conduct; to ensure the Bank has adequate systems to enforce the Code of Conduct; to resolve complex ethical dilemmas;
- (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 Bank'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.

Three (3) Remuneration Committee meetings were held during the year. Major works performed during the year include:

- (1) Review of remuneration policies;
- (2) Review of the Terms of Reference of the Remuneration Committee;
- (3) Review and amendment to the Staff Code of Conduct;
- (4) Consideration of the proposal on staff bonus for year 2019 and of the proposal on salary adjustment for year 2020;
- (5) Consideration of the report on independent compliance review of HKMA CG-5 prepared by consultancy firm;
- (6) Listening to the report of the annual audit review on remuneration policies; and
- (7) Listening to the implementation report on bank culture reform.

Unaudited Supplementary Financial Information

For the year ended 31 December 2020

6 Risk Management Committee

The function of Risk Management Committee is as follow:

- (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 Bank.
- (3) To review and access the risk management process of the Bank, 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. After considering the business and risk strategy, to ensure the Bank has adequate capital to cater for major risk.

Risk Management Committee is composed of 3 Independent Non-executive Directors and 1 Executive Director. Five (5) Risk Management Committee meetings were held in the year 2020. The major task completed by Risk Management Committee included the following:

- (1) Review and recommend risk management strategy, and risk level/appetite that could be accepted by the Bank for Board approval;
- (2) Review and access whether the risk management structure and policies is able to identify, measure, monitor and control the risk faced by the Bank; and if the risk management structure and policies function effectively;
- (3) Review the report from Comprehensive Risk Management Committee about the risk exposures and risk management activities;
- (4) Review and approve high level risk policies and measures;
- (5) Approve various risk management limits; and
- (6) Review and recommend the Recovery Plan for Board approval.

The Risk Management Committee comprises at least three members. Current members of the Risk Management Committee are Mr. Lam Yim Nam (Chairman of the Risk Management Committee), Mr. Tang Kwai Chang, Ms. Chan Ching Har Eliza and Mr. Fan Chaorong.