NOTES TO THE FINANCIAL STATEMENTS

1. Principal activities

The Company is an investment holding company and its subsidiaries are principally engaged in the provision of banking and related financial services in Hong Kong.

The Company is a limited liability company incorporated and listed in Hong Kong. The address of its registered office is 52/F, Bank of China Tower, 1 Garden Road, Hong Kong.

2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below.

These policies have been consistently applied to all the years presented, unless otherwise stated.

2.1 Basis of preparation

The consolidated financial statements of the Group have been prepared in accordance with Hong Kong Financial Reporting Standards (HKFRSs is a collective term which includes all applicable individual Hong Kong Financial Reporting Standards, HKASs and Interpretations) issued by the HKICPA, HK GAAP and the requirements of the Hong Kong Companies Ordinance.

The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale securities, financial assets and financial liabilities (including derivative financial instruments) at fair value through profit or loss, investment properties which are carried at fair value and premises which are carried at fair value or revalued amount less accumulated depreciation and accumulated impairment losses.

The preparation of financial statements in conformity with HKFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 3.

Newly adopted HKFRSs

The HKAS 39, 'Financial instruments: Recognition and measurement', amendment on reclassification of financial assets permits reclassification of certain financial assets out of the held-for-trading and available-for-sale categories if specified conditions are met. The related amendment to HKFRS 7, 'Financial instruments: Disclosures', introduces disclosure requirements with respect to financial assets reclassified out of the held-for-trading and available-for-sale categories. The amendment is effective prospectively from 1 July 2008. This amendment does not have any impact on the Group's financial statements as the Group has not reclassified any financial assets.

Interpretations to existing standards already effective in 2008 but not relevant to the Group's operations

The following Interpretations to existing standards have already been effective for accounting periods beginning on 1 January 2008 but are not relevant to the Group's operations:

- HK(IFRIC)-Int 11, 'HKFRS 2 Group and Treasury Share Transactions' (effective for annual periods beginning on or after 1 March 2007).

- HK(IFRIC)-Int 12, 'Service Concession Arrangements' (effective for annual periods beginning on or after 1 January 2008).

- HK(IFRIC)-Int 14, 'HKAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction' (effective for annual periods beginning on or after 1 January 2008).

2. Summary of significant accounting policies (continued)

2.1 Basis of preparation (continued)

Standards and interpretations to existing standards that are not yet effective and have not been early adopted by the Group

The Group has chosen not to early adopt the following standards and an interpretation to an existing standard that were issued but not yet effective for accounting periods beginning on 1 January 2008:

- HKAS 1 (Revised), 'Presentation of financial statements' (effective from 1 January 2009). The revised standard will prohibit the presentation of items of income and expenses (that is, 'non-owner changes in equity') in the statement of changes in equity, requiring 'non-owner changes in equity' to be presented separately from owner changes in equity. All non-owner changes in equity will be required to be shown in a performance statement. Where entities restate or reclassify comparative information, they will be required to present a restated balance sheet as at the beginning comparative period in addition to the current requirement to present balance sheets at the end of the current period and comparative period. The adoption of this revised standard will affect the presentation of the Group's financial statements.

- HKAS 27 (Revised), 'Consolidated and separate financial statements' (effective from 1 July 2009). The revised standard requires changes in a parent's ownership interest in a subsidiary that do not result in the loss of control are accounted for within equity. The standard also specifies the accounting when control is lost. Any remaining interest in the entity is re-measured to fair value and a gain or loss is recognised in income statement. The Group will apply HKAS 27 (Revised) prospectively from 1 January 2010.

- HKFRS 3 (Revised), 'Business combinations' (effective from 1 July 2009). The revised standard continues to apply the acquisition method to business combinations, with some significant changes. For example, all payments to purchase a business are to be recorded at fair value at the acquisition date, with contingent payments classified as debt subsequently re-measured through the consolidated income statement. All acquisition-related costs should be expensed. The Group will apply HKFRS 3 (Revised) to all business combinations (other than common control combination) acquired on or after 1 January 2010.

- HKFRS 8 'Operating Segments' (effective from 1 January 2009). HKFRS 8 will supersede HKAS 14 Segment Reporting, under which segments were identified and reported on risk and return analysis. Items were reported on the accounting policies used for external reporting. Under HKFRS 8, which adopts the 'management approach', segments are components of an entity regularly reviewed by the entity's management. Items are presented based on internal reporting. The Group will adopt HKFRS 8 with effect from 1 January 2009 and will accordingly present segmental information which reflects the operating segments used to make operating decisions at that time.

- HK(IFRIC)-Int 13 'Customer Loyalty Programmes' (effective from 1 July 2008). HK(IFRIC)-Int 13 clarifies that when an entity provides customers with incentives to buy goods or services under a customer loyalty programme (for example, customers accumulate loyalty points to redeem free or discounted products or service), the fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the award credits and the other components of the sale or service. The Group will apply the interpretation from 1 January 2009. It is not expected to have significant impact on the Group's results of operations and financial position.

- There are a number of improvements and amendments to HKFRS published in October 2008 by HKICPA which are not addressed above. The following amendments are unlikely to have a significant impact on the Group's financial statements and have therefore not been analysed in details.

    - HKAS 1 (Amendment), 'Presentation of financial statements' (effective from 1 January 2009)

2. Summary of significant accounting policies (continued)

2.1 Basis of preparation (continued)

Standards and interpretations to existing standards that are not yet effective and have not been early adopted by the Group (continued)

- HKAS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' (effective from 1 January 2009)
- HKAS 10, 'Events after the Balance Sheet Date' (effective from 1 July 2009)
- HKAS 18, 'Revenue' (effective from 1 January 2009)
- HKAS 34, 'Interim Financial Reporting' (effective from 1 January 2009)
- HKAS 39 (Amendment), 'Financial instruments: Recognition and measurement' (effective from 1 July 2009)
- HKFRS 5 (Amendment), 'Non-current assets held for sale and discontinued operations' (effective from 1 July 2009)
- HKFRS 7, 'Financial instruments: Disclosures' (effective from 1 January 2009)

Standards, amendments and interpretations to existing standards that are not yet effective and have been assessed to be not relevant to the Group's operations

- HKAS 16 (Amendment), 'Property, plant and equipment' (and consequential amendment to HKAS 7, 'Statement of cash flows') (effective from 1 January 2009)
- HKAS 19 (Amendment), 'Employee benefits' (effective from 1 January 2009)
- HKAS 20 (Amendment), 'Accounting for government grants and disclosure of government assistance' (effective from 1 January 2009)
- HKAS 23 (Revised) 'Borrowing costs' (effective from 1 January 2009)
- HKAS 23 (Amendment), 'Borrowing costs' (effective from 1 January 2009)
- HKAS 27 (Amendment), 'Consolidated and separate financial statements' (effective from 1 January 2009)
- HKAS 28 (Amendment), 'Investment in associates' (and consequential amendments to HKAS 32, 'Financial instruments: Presentation' and HKFRS 7, 'Financial instruments: Disclosures') (effective from 1 January 2009)
- HKAS 29 (Amendment), 'Financial reporting in hyperinflationary economies' (effective from 1 January 2009)
- HKAS 31 (Amendment), 'Interests in joint ventures' (and consequential amendments to HKAS 32 and HKFRS 7) (effective from 1 January 2009)
- HKAS 32 (Amendment), 'Financial instruments: Presentation', and HKAS 1 (Amendment), 'Presentation of financial statements', 'Puttable financial instruments and obligations arising on liquidation' (effective from 1 January 2009)

2. Summary of significant accounting policies (continued)

2.1 Basis of preparation (continued)

Standards, amendments and interpretations to existing standards that are not yet effective and have been assessed to be not relevant to the Group's operations (continued)

- HKAS 38 (Amendment), 'Intangible assets' (effective from 1 January 2009)
- HKAS 40 (Amendment), 'Investment property' (and consequential amendments to HKAS 16) (effective from 1 January 2009)
- HKAS 41 (Amendment), 'Agriculture' (effective from 1 January 2009)
- HKFRS 1 (Amendment), 'First time adoption of HKFRS' and HKAS 27 'Consolidated and separate financial statements' (effective from 1 January 2009)
- HKFRS 2 (Amendment), 'Share-based payment' (effective from 1 January 2009)
- HK(IFRIC)-Int 15, 'Agreements for construction of real estates' (effective from 1 January 2009 and supercedes HK Int-3, 'Revenue – Pre-completion contracts for the sale of development properties)
- HK(IFRIC)-Int 16, 'Hedges of a net investment in a foreign operation' (effective from 1 October 2008)
- HK(IFRIC)-Int 17, 'Distributions of non-cash assets to owners' (effective from 1 July 2009)
- HK(IFRIC)-Int 18, 'Transfers of assets from customers' (effective from 1 July 2009)

2.2 Consolidation

The consolidated financial statements include the financial statements of the Company and all of its subsidiaries made up to 31 December.

(1) Subsidiaries

Subsidiaries are all entities (including special purpose entities) over which the Group controls the composition of the Board of Directors, controls more than half of the voting power, holds more than half of the issued capital or by any other means that entitle the Group to govern the financial and operating policies of the entities. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date that control ceases.

For acquisition of a company under common control, the merger accounting method will be applied. The principle of merger accounting is a way to combine companies under common control as though the business of the acquired company had always been carried out by the acquirer. The Group's consolidated financial statements represent the consolidated results, consolidated cash flows and consolidated financial position of the Group as if any such combination had occurred from the date when the Company and the acquired company first came under common control (i.e. no fair value adjustment on the date of combination is required). The difference between the consideration and carrying amount at the time of combination is treated as a merger reserve in equity. The effects of all transactions between the Group and the acquired company, whether occurring before or after the combination, are eliminated in preparing the consolidated financial statements of the Group. The transaction costs for the combination will be expensed in the income statement.

2. Summary of significant accounting policies (continued)

2.2 Consolidation (continued)

(1) Subsidiaries (continued)

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group not under common control. The cost of such an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed as of the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values as of the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the Group's share of the identifiable net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Inter-company transactions, balances and unrealised gains on transactions between group companies are eliminated; unrealised losses are also eliminated unless the transaction provides evidence of impairment of the assets transferred. Where necessary, accounting policies of subsidiaries have been changed to ensure consistency with the policies adopted by the Group.

In the Company's balance sheet the investments in subsidiaries are stated at cost less allowance for impairment losses. The results of subsidiaries are accounted for by the Company on the basis of dividends received and receivable.

The gain or loss on the disposal of a subsidiary represents the difference between: (a) the proceeds of the sale and, (b) the Group's share of its net assets including goodwill on acquisition net of any accumulated impairment loss and any related accumulated foreign currency translation difference.

Minority interest represent the interests of outside shareholders in the operating results and net assets of subsidiaries.

(2) Associates

Associates are all entities over which the Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes goodwill, net of accumulated impairment loss and any related accumulated foreign currency translation difference.

The Group's share of the post-acquisition profits or losses of associates is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves. The cumulative post-acquisition movements are adjusted against the cost of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, the Group does not recognise further losses unless the Group has incurred obligations or made payments on behalf of the associates.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates; unrealised losses are also eliminated unless the transaction provides evidence of impairment of the asset transferred.

In the Company's balance sheet the investments in associates are stated at cost less allowance for impairment losses. The results of associates are accounted for by the Company on the basis of dividends received and receivable.

2. Summary of significant accounting policies (continued)

2.3 Segmental reporting

A business segment is a group of assets and operations engaged in providing products and services and that is subject to risks and returns that are different from those of other business segments. A geographical segment is a group of assets and operations engaged in providing products and services within a particular economic environment and that is subject to risks and returns that are different from those of segments operating in other economic environments.

2.4 Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The consolidated financial statements are presented in Hong Kong dollars, which is the Company's functional and presentation currency.

Foreign exchange gains and losses resulting from the settlement of foreign currency transactions using the exchange rates prevailing at the dates of the transactions and monetary assets and liabilities denominated in foreign currencies translated at the rate of exchange at the balance sheet date are recognised directly in the income statement.

Changes in the fair value of monetary securities denominated in foreign currency classified as available-for-sale are analysed between translation differences resulting from changes in the amortised cost of the securities and other changes in the carrying amount of the securities. Translation differences related to changes in the amortised cost are recognised in the income statement, and other changes in the carrying amount are recognised in equity.

Translation differences on non-monetary items, such as equities held at fair value through profit or loss, are reported as part of the fair value gain or loss. Translation differences on non-monetary financial assets such as equities classified as available-for-sale are included in the available-for-sale reserve in equity.

The results and financial position of all the Group entities that have a functional currency different from Hong Kong dollars are translated into Hong Kong dollars as follows:

- assets and liabilities are translated at the closing rate at the balance sheet date;
- income and expenses are translated at average exchange rates; and
- all resulting exchange differences are recognised in the currency translation reserve in equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments are taken to shareholders' equity. When a foreign entity is sold, such exchange differences are recognised in the income statement, as part of the gain or loss on sale.

2.5 Derivative financial instruments and hedge accounting

Derivatives are initially recognised at fair value on the date the derivative contract is entered into and are subsequently re-measured at fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and through the use of valuation techniques, including discounted cash flow models and options pricing models, as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

Derivatives are categorised as held for trading unless they are designated as hedges and are effective hedging instruments, then they are subject to measurement under the hedge accounting requirements.

2. Summary of significant accounting policies (continued)

2.5 Derivative financial instruments and hedge accounting (continued)

The best evidence of the fair value of a derivative at initial recognition is the transaction price (i.e., the fair value of the consideration given or received).

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

The Group designates certain derivatives as hedges of the fair value of recognised assets or liabilities or firm commitments (fair value hedge). Hedge accounting is used for derivatives designated in this way.

The Group documents at inception the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Group also documents its assessment, both at the 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 of hedged items. These criteria should be met before a hedge can be qualified to be accounted for under hedge accounting.

Changes in the fair value of derivatives that are designated and qualified as effective fair value hedges are recorded in the income statement, together with any 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 amortised to the income statement over the period to maturity.

For derivative instruments held for trading changes in their fair value are recognised immediately in the income statement.

2.6 Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

2.7 Interest income and expense and fees and commission income and expense

Interest income and expense are recognised in the income statement for all financial assets and financial liabilities using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. 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 Group estimates cash flows considering all contractual terms of the financial instrument (e.g. prepayment options or incentives relating to residential mortgage loans) but does not consider future credit losses. The calculation includes fees, premiums or discounts and basis points paid or received between parties to the contract, and directly attributable origination fees and costs which represent an integral part of the effective yield are amortised as interest income or expense over the expected life of the financial instrument.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised on the written down value using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. Subsequent unwinding of the discount allowance is recognised as interest income.

2. Summary of significant accounting policies (continued)

2.7 Interest income and expense and fees and commission income and expense (continued)

Fees and commissions that are not an integral part of the effective yield are recognised on an accrual basis ratably over the period when the related service has been provided, such as administrative fee, asset management fee and custody services fee. Loan syndication fees are recognised as revenue when the related syndication arrangement has been completed and the Group has retained no part of the loan package for itself or has retained a part at the same effective interest rate as that of other participants.

2.8 Financial assets

The Group classifies its financial assets into the following categories: financial assets at fair value through profit or loss; loans and receivables; held-to-maturity investments and available-for-sale financial assets. Management determines the classification of investments at initial recognition. The classification depends on the purpose for which the financial assets were held. All financial assets are recognised initially at fair value. Except for financial assets carried at fair value through profit or loss, all transaction costs of financial assets are included in their amortised costs.

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

This category has two sub-categories: financial assets held for trading, and those designated at fair value through profit or loss at inception.

A financial asset which has been acquired or incurred principally for the purpose of selling in the short term or is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking is classified as held-for-trading. Derivatives are also classified as held for trading unless they are designated as effective hedges.

A financial asset, other than one held for trading, will be designated as a financial asset at fair value through profit or loss, if it meets the criteria set out below, and is so designated by management:

- eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring the financial assets or recognising the gains and losses on them on different bases; or

- applies to a group of financial assets, financial liabilities or both that is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the key management; or

- relates to financial assets containing one or more embedded derivative that significantly modifies the cash flow resulting from those financial assets.

These assets are recognised initially at fair value, with transaction costs taken directly to the consolidated income statement, and are subsequently re-measured at fair value.

Gains and losses from changes in the fair value of such assets (excluding the interest component) are reported in net trading income or net gain/loss on financial instruments designated at fair value through profit or loss. The interest component is reported as part of interest income. Dividends on equity instruments of this category are recognised in the consolidated income statement when the Group's right to receive payment is established.

2. Summary of significant accounting policies (continued)

2.8 Financial assets (continued)

(2) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, including placements with and advances to banks and other financial institutions, investment debt securities without an active market and loans and advances to customers. They arise when the Group provides money, goods or services directly to a debtor with no intention of trading the receivable. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest rate method less allowances for impairment losses.

(3) Held-to-maturity

Financial assets classified as held-to-maturity are those traded in active markets, with fixed or determinable payments and fixed maturities that the Group's management has both the positive intention and the ability to hold to maturity. Were the Group to sell other than an insignificant amount of held-to-maturity assets, the entire category would be tainted and reclassified as available-for-sale. They are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method less allowances for impairment losses.

(4) Available-for-sale

Financial assets classified as available-for-sale are those that are either designated as such or are not classified in any of the other categories. They are intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices.

Available-for-sale financial assets are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at fair value. Unrealised gains and losses arising from changes in the fair value of investments are recognised directly in equity, until the financial asset is disposed of or impaired at which time the cumulative gain or loss previously recognised in equity should be transferred to the consolidated income statement. However, interest which includes the amortisation of premium and discount is calculated using the effective interest method and is recognised in the consolidated income statement. Dividends on equity instruments classified as available-for-sale are recognised in the consolidated income statement when the Group's right to receive payment is established.

2.9 Financial liabilities

The Group classifies its financial liabilities under the following categories: trading liabilities, financial liabilities designated at fair value through profit or loss, deposits, debt securities in issue, subordinated liabilities, and other liabilities. All financial liabilities are classified at inception and recognised initially at fair value.

(1) Trading liabilities

A financial liability is classified as held for trading if it is incurred principally for the purpose of repurchasing in the short term. Derivatives are also classified as held for trading unless they are designated as effective hedges. It is measured at fair value and any gains and losses from changes in fair value are recognised in the income statement.

2. Summary of significant accounting policies (continued)

2.9 Financial liabilities (continued)

(2) Financial liabilities designated at fair value through profit or loss

A financial liability can be designated at fair value through profit or loss if it is so designated at inception. Financial liabilities so designated include certain certificates of deposit issued and certain deposits received from customers that are embedded with derivatives. A financial liability is typically so designated if it meets the following criteria:

- eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring the financial liabilities or recognising the gains and losses on them on different bases; or

- applies to a group of financial assets, financial liabilities or both that is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the key management; or

- relates to financial liabilities containing one or more embedded derivative that significantly modifies the cash flow resulting from those financial liabilities.

Financial liabilities designated at fair value through profit or loss are measured at fair value and any gains and losses from changes in fair value are recognised in the income statement.

(3) Deposits, debt securities in issue, subordinated liabilities and other liabilities

Deposits and debt securities in issue other than those classified as trading liabilities or designated at fair value through profit or loss, together with subordinated liabilities and other liabilities are carried at amortised cost or at cost. Any difference (if available) between proceeds net of transaction costs and the redemption value is recognised in the income statement over the period using the effective interest method.

2.10 Recognition and de-recognition of financial instruments

Purchases and sales of financial assets at fair value through profit or loss, available-for-sale and held-to-maturity are recognised on the trade date, the date on which the Group purchases or sells the assets. Loans and receivables (except investment securities without an active market) are recognised when cash is advanced to the borrowers. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Trading liabilities, financial liabilities designated at fair value through profit or loss and debt securities in issue are recognised on the trade date. Deposits other than trading liabilities are recognised when money is received from customers, other liabilities are recognised when such obligations arise. Financial liabilities are de-recognised from the balance sheet when and only when the obligation specified in the contract is discharged, cancelled or expired. If the Group purchases its own debt, it is removed from the balance sheet, and the difference between the carrying amount of a liability and the consideration paid is included in net trading income.

Securities and bills sold to a counter-party with an obligation to repurchase at a pre-determined price on a specified future date under a repurchase agreement are referred to as Repos. Securities and bills purchased from a counter-party with an obligation to re-sell to the counter-party at a pre-determined price on a specified future date under a resale agreement are referred to as Reverse repos.

2. Summary of significant accounting policies (continued)

2.10 Recognition and de-recognition of financial instruments (continued)

Repos or securities lending are initially recorded as due to banks, placements from banks and other financial institutions, as appropriate, at the actual amount of cash received from the counter-party. The financial assets used to collateralise repurchase agreements are recorded as investment securities or financial assets at fair value through profit or loss. Reverse repos or securities borrowing are initially recorded in the balance sheet as cash and due from banks or placements with banks and other financial institutions, as appropriate, at the actual amount of cash paid to the counter-party. The financial assets received as collateral under reverse repurchase agreements are not recorded on the balance sheet. The difference between sale and repurchase price is recognised as interest income or interest expense over the life of the agreements using the effective interest method.

2.11 Determination of fair value of financial instruments

The fair values of financial assets and financial liabilities that are quoted in active markets are based on current bid prices and current ask prices respectively. If the market for financial assets and financial liabilities is not active (such as unlisted securities), the Group establishes fair value by using valuation techniques. These include the use of recent arm's length transactions, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

2.12 Precious metals

Precious metals comprise gold, silver and other precious metals. Precious metals are initially recognised at fair value and subsequently re-measured at their respective market prices as of the balance sheet date. Mark-to-market gains or losses on precious metals are included in net trading income.

2.13 Impairment of financial assets

The Group assesses as of each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence that a financial asset or group of assets may be impaired includes observable data that comes to the attention of the Group about the following probable loss events:

(i) significant financial difficulty of the issuer or obligor;

(ii) a breach of contract, such as a default or delinquency in interest or principal payment;

(iii) the Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a concession that the lender would not otherwise consider;

(iv) it becoming probable that the borrower will enter into bankruptcy or other financial reorganisation;

(v) the disappearance of an active market or downgrading below investment grade level for that financial asset because of financial difficulties; or

(vi) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

- adverse changes in the payment status of borrowers in the group; or
- national or local economic conditions that correlate with defaults on the assets in the group.

2. Summary of significant accounting policies (continued)

2.13 Impairment of financial assets (continued)

(1) Assets carried at amortised cost

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment together with all other financial assets that are not individually significant or for which impairment has not yet been identified. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement. If a loan or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract. As a practical expedient, the Group may measure impairment on the basis of an instrument's fair value using an observable market price.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral.

For the purposes of a collective assessment of impairment, financial assets are grouped on the basis of similar and relevant credit risk characteristics. Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

When a loan is uncollectible, it is written off against the related allowance for impairment losses. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses in the income statement.

If, in a subsequent period, the amount of allowance for impairment losses decreases and the decrease can be related objectively to an event occurring after the impairment loss was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement.

Loans whose terms have been renegotiated with substantial difference in the terms are no longer considered to be past due but are treated as new loans.

2. Summary of significant accounting policies (continued)

2.13 Impairment of financial assets (continued)

(2) Assets classified as available-for-sale

If evidence of impairment exists for available-for-sale financial assets, the cumulative losses, measured as the difference between the acquisition cost or amortised cost and the current fair value, less any impairment loss on that financial asset previously recognised in the income statement, is removed from equity and recognised in the income statement. In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement. With respect to equity instruments, such reversals are made through the reserve for fair value change of available-for-sale securities within equity.

2.14 Impairment of investment in subsidiaries and associates and non-financial assets

Assets that have an indefinite useful life or are not yet available for use are not subject to amortisation, but are tested annually for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units). Assets that suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

2.15 Financial guarantee contracts

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 contract between the holder and the debtor.

Financial guarantees are initially recognised as financial liabilities and reported under "Other accounts and provisions" in the financial statements at fair value on the date that the guarantee was given. Subsequent to initial recognition, the Group's liabilities under such guarantees are measured at the higher of (i) the amount determined in accordance with HKAS 37 Provisions, Contingent Liabilities and Contingent Assets and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised over the life of the guarantee on a straight-line basis. Any changes in the liability relating to financial guarantees are taken to the income statement.

2.16 Fixed assets

(1) Premises, equipment, fixtures and fittings

Premises comprise primarily branches and offices. Premises are shown at fair value based on periodic, but at least annually, valuations by external independent valuers less subsequent depreciation. Any accumulated depreciation at the date of revaluation is eliminated against the gross carrying amount of the asset and the net amount is restated to the revalued amount of the asset. In the intervening periods, the directors review the carrying amount of premises, by reference to the open market value of similar properties, and adjustments are made when there has been a material change. All equipment, fixtures and fittings are stated at historical cost less accumulated depreciation and impairment. Historical cost includes expenditures that are directly attributable to the acquisition and installation of the items.

Subsequent costs are included in an asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the income statement during the financial period in which they are incurred.

2. Summary of significant accounting policies (continued)

2.16 Fixed assets (continued)

(1) Premises, equipment, fixtures and fittings (continued)

Increases in the carrying amount arising on revaluation of premises are credited to the premises revaluation reserve in shareholders' equity. Decreases that offset previous increases of the same individual asset are charged against premises revaluation reserve directly in equity; all other decreases are expensed in the income statement. Any subsequent increases are credited to the income statement up to the amount previously debited, and then to the premises revaluation reserve. Upon disposal of premises, the relevant portion of the premises revaluation reserve realised in respect of previous valuations is released and transferred from the premises revaluation reserve to retained earnings.

Depreciation is calculated on the straight-line method to write down the cost or revalued amount of such assets over their estimated useful lives as follows:

• Premises	Over the remaining period of lease
• Equipment, fixtures and fittings	3-15 years

The useful lives of assets are reviewed, and adjusted if appropriate, as of each balance sheet date.

At each balance sheet date, both internal and external sources of information are considered to determine whether there is any indication that premises, equipment, fixtures and fittings are impaired. If any such indication exists, the recoverable amount of the asset is estimated and where relevant, an impairment loss is recognised to reduce the asset to its recoverable amount. Such impairment loss is recognised in the income statement except where the asset is carried at valuation and the impairment loss does not exceed the revaluation surplus for that same asset, in which case it is treated as a revaluation decrease. The recoverable amount is the higher of the asset's fair value less costs to sell and value in use. Impairment loss is reversed through the premises revaluation reserve or income statement as appropriate.

Gains and losses on disposals are determined by comparing proceeds with carrying amount, relevant taxes and expenses. These are included in the income statement.

(2) Property under development

Property under development represents assets under construction or being installed and is stated at cost less impairment losses. Cost includes equipment cost, cost of development, construction, installation, interest and other direct costs attributable to the development. Items classified as property under development are transferred to premises or investment properties when such assets are ready for their intended use, and the depreciation charge commences from the month such assets are transferred to premises.

Impairment losses are recognised for idle projects with respect to which management has determined that resumption in the foreseeable future is not probable. The impairment loss is equal to the extent to which the estimated recoverable amount of a specific project is less than its carrying amount. The recoverable amount is the asset's fair value less costs to sell. Impairment losses or reversals are charged to the income statement.

2.17 Investment properties

Properties that are held for long-term rental yields or for capital appreciation or both, and that are not occupied by the companies in the Group, are classified as investment properties. Properties leased out within group companies are classified as investment properties in individual companies' financial statements and as premises in consolidated financial statements. Land held under operating lease is classified and accounted for as investment property when the rest of the definition of investment property is met. The operating lease is accounted for as if it is a finance lease.

2. Summary of significant accounting policies (continued)

2.17 Investment properties (continued)

Investment properties are recognised initially at cost, including related transaction costs. After initial recognition, investment properties are measured at fair value assessed by professional valuers on the basis of open market value. If this information is not available, alternative valuation methods are used such as recent prices on less active markets or discounted cash flow projections. These valuations are performed in accordance with the guidance issued by the International Valuation Standards Committee.

Subsequent expenditure is charged to the asset's carrying amount only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are expensed in the income statement during the financial period in which they are incurred.

Any changes in fair value are reported directly in the income statement. Deferred income tax is provided on revaluation surpluses of investment properties in accordance with HKAS-Int 21 "Income Taxes – Recovery of Revalued Non-Depreciable Assets" on HKAS 12 "Income Taxes".

If an investment property becomes owner-occupied, it is reclassified as premises, and its fair value at the date of reclassification becomes its cost for accounting purposes. If an item of premises becomes an investment property because its use has changed, any difference resulting between the carrying amount and the fair value of this item at the date of transfer is recognised in equity as a revaluation of premises under HKAS 16 "Property, Plant and Equipment". However, if a fair value gain reverses a previous revaluation loss or impairment loss, the gain is recognised in the income statement up to the amount previously debited.

2.18 Leases

(1) Operating leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. The total payments made under operating leases (net of any incentives received from the lessor) which include land use rights with payments that are separately identifiable at inception of the lease are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

Where the Group is a lessor, the land and buildings subject to the operating lease are accounted for as investment properties. Rental income from operating leases is recognised on a straight-line basis over the lease term.

(2) Finance leases on properties

Where the land and buildings elements of leasehold properties held for own use can be split reliably at inception of the lease, leasehold land and land use rights are recognised as operating leases if they have indefinite economic lives. The up-front prepayments made or other costs incurred for acquiring the leasehold land and land use rights are expensed in the income statement on a straight-line basis over the period of the lease. Where there is impairment of the up-front prepayments, the impairment is expensed in the income statement immediately. Where the land and buildings cannot be split reliably at inception of the lease, the land and buildings elements will continue to be treated as finance leases and measured at fair value.

Separate measurements of the land and buildings elements are not required when the Group's interest in both land and buildings is classified as investment properties as if they are finance leases and are measured at fair value.

2. Summary of significant accounting policies (continued)

2.18 Leases (continued)

(2) Finance leases on properties (continued)

Pursuant to the Bank of China (Hong Kong) Limited (Merger) Ordinance ("Merger Ordinance") 2001, all assets and liabilities of the designated branches and subsidiaries, and the shares of certain entities of the legacy Bank of China Group in Hong Kong were effectively transferred to BOCHK, which was immediately owned by the then newly formed BOC Hong Kong (Holdings) Limited ("the Merger"). This was a significant event and the Group has therefore adopted the valuation at the date of the Merger as the deemed cost for its leasehold properties to reflect the circumstances at the time of the Merger.

On adoption of the deemed cost at the date of Merger, the Group made reference to the independent property valuation conducted as at 31 August 2001 for the purpose of the Merger, which did not split the values of the leasehold properties between the land and buildings elements. Any means of subsequent allocation of the valuation of the leasehold properties at the date of Merger between the land and buildings elements would be notional and therefore would not represent reliable information. It is determined that the values of the land and buildings elements of the Group's leasehold properties cannot be reliably split and the leasehold properties are treated as finance leases. The Group has also adopted the revaluation model under HKAS 16 "Property, Plant and Equipment" by which assets held for own use arising under these finance leases are measured at fair value less any accumulated depreciation and impairment losses.

2.19 Insurance contracts

(1) Insurance contracts classification, recognition and measurement

The Group's insurance subsidiary follows the local regulatory requirements to measure its insurance contract liabilities.

The Group's insurance subsidiary issues insurance contracts that transfer significant insurance risk. As a general guideline, the Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event that are at least 10% more than the benefit payable if the insured event did not occur. The Group's insurance subsidiary issues long term business insurance contracts, which insure events associated with human life (for example death, survival, or total permanent disability) over a long duration. A liability for contractual benefits that are expected to be incurred in the future is recorded when premiums are recognised.

For linked long term insurance contracts with embedded derivatives (which are closely related to the host insurance contracts) linking payments on the contract to units of an investment fund set up by the Group with the consideration received from the contract holders, the liability is adjusted for all changes in the fair value of underlying assets, and includes a liability for contractual benefits that are expected to be incurred in the future which is recorded when the premiums are recognised.

Retirement scheme management category III insurance contracts, as defined in the Insurance Companies Ordinance, insure events associated with human life under retirement schemes. A liability for contractual benefits that are expected to be incurred in the future is recorded when premiums are recognised. The portion of the premium received on in-force contracts that relates to unexpired risks at the balance sheet date is reported as the unearned premium liability.

Premiums are recognised as revenue when they become payable by the contract holders before the deduction of commissions. Benefits and claims are recorded as an expense when they are incurred.

The Group does not separately measure embedded derivatives that meet the definition of an insurance contract or options to surrender insurance contracts for a fixed amount (or an amount based on a fixed amount and an interest rate).

2. Summary of significant accounting policies (continued)

2.19 Insurance contracts (continued)

(2) Liability adequacy test

At each balance sheet date, liability adequacy tests are performed to ensure the adequacy of the insurance contract liabilities. In performing these tests, current best estimates of future contractual cash flows and claims handling and administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to the consolidated income statement, with a provision established for losses arising from the liability adequacy test.

2.20 Cash and cash equivalents

For the purposes of the consolidated cash flow statement, cash and cash equivalents comprise balances with original maturity less than three months from the date of acquisition, including cash, balances with banks and other financial institutions, short-term bills and notes classified as investment securities and certificates of deposit.

2.21 Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

2.22 Employee benefits

(1) Retirement benefit costs

The Group contributes to defined contribution retirement schemes under either recognised ORSO schemes or MPF schemes that are available to the Group's employees. Contributions to the schemes by the Group 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. The retirement benefit scheme costs are charged to the income statement as incurred and represent contributions payable by the Group to the schemes. Contributions made by the Group that are forfeited by those employees who leave the ORSO scheme prior to the full vesting of their entitlement to the contributions are used by the Group to reduce the existing level of contributions or to meet its expenses under the trust deed of the ORSO schemes.

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

(2) Leave entitlements

Employee entitlements to annual leave and sick leave are recognised when they accrue to employees. A provision is made for the estimated liability for unused annual leave and the amount of sick leave expected to be paid as a result of services rendered by employees up to the balance sheet date.

Compensated absences other than annual leave and sick leave are non-accumulating; they lapse if the current period's entitlement is not used in full and do not entitle employees to a cash payment for unused entitlement on leaving the Group. Such compensated absences are recognised when the absences occur.

(3) Bonus plans

The expected cost of bonus payments are recognised as a liability when the Group has a present legal or constructive obligation as a result of services rendered by employees and a reliable estimate of the obligation can be made. Liabilities for bonus plans are expected to be settled within twelve months and are measured at the amounts expected to be paid when they are settled.

2. Summary of significant accounting policies (continued)

2.23 Current and deferred income taxes

Tax expenses for the period comprises current and deferred tax. Tax is recognised in the income statement, except to the extent that it relates to items recognised directly in equity. In this case, the tax is also recognised in equity.

Income tax payable on profits, based on the applicable tax law enacted or substantially enacted at the balance sheet date in each jurisdiction where the Company and the subsidiaries and associates operate and generate taxable income, is recognised as a current income tax expense in the period in which profits arise.

Deferred income tax is provided in full, using the balance sheet liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates and laws that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

The principal temporary differences arise from asset impairment provisions, depreciation of property and equipment, revaluation of certain assets including available-for-sale securities and properties, and tax losses carried forward. However, the deferred income tax is not recognised if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss.

Deferred income tax liabilities are provided in full on all taxable temporary differences and deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred income tax is charged or credited in the income statement except for deferred income tax relating to fair value re-measurement of available-for-sale investments and revaluation of premises which are charged or credited directly to equity, in which case the deferred income tax is also credited or charged directly to equity and is subsequently recognised in the income statement together with the realisation of the deferred gain and loss.

2.24 Repossessed assets

Repossessed assets are initially recognised at the lower of their fair value less costs to sell and the amortised cost of the related outstanding loans on the date of repossession, and the related loans and advances together with the related impairment allowances are derecognised from the balance sheet. Subsequently, repossessed assets are measured at the lower of their cost and fair values less costs to sell and are reported as 'Non-current assets held for sale' under 'Other assets'.

2.25 Fiduciary activities

The Group commonly acts as a trustee, or in other fiduciary capacities, that result in its holding or managing assets on behalf of individuals, trusts and other institutions. These assets and any income or losses arising thereon are excluded from these financial statements, as they are not assets of the Group.

2.26 Contingent liabilities and contingent assets

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 Group. It can also be a present obligation arising from past events that is not recognised because it is not probable that an outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

2. Summary of significant accounting policies (continued)

2.26 Contingent liabilities and contingent assets (continued)

A contingent liability is not recognised as a provision 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, it will then be recognised as a provision.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the Group.

Contingent assets are not recognised but are disclosed in the notes to the financial statements when an inflow of economic benefits is probable. When the inflow is virtually certain, it will be recognised as an asset.

2.27 Related parties

For the purposes of these financial statements, a party is considered to be related to the Group if the Group has the ability, directly and indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control. Related parties may be individuals or entities.

3. Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Areas susceptible to changes in essential estimates and judgements, which affect the carrying amount of assets and liabilities, are set out below. The effect of changes to either the key assumptions or other estimation uncertainties will be presented below if it is practicable to determine. It is possible that actual results may require material adjustments to the estimates referred to below.

3.1 Impairment allowances on loans and advances

The Group reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the income statement, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans and advances before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group (e.g. payment delinquency or default), or economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when estimating expected future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

3.2 Impairment of held-to-maturity and available-for-sale investments

The Group reviews its held-to-maturity and available-for-sale investment portfolios to assess impairment at least on a quarterly basis. In determining whether any of these investments is impaired, risk characteristics and performance such as external credit rating, market price etc will be assessed. The Group makes estimates on the default rate and loss severity of each investment with reference to market performance of the portfolios, current payment status of the issuers or performance of the underlying assets, or economic conditions that correlate with defaults on the collateralised assets.

3. Critical accounting estimates and judgements in applying accounting policies (continued)

3.2 Impairment of held-to-maturity and available-for-sale investments (continued)

For asset/mortgage backed securities ("ABS/MBS"), the Group adopts a comprehensive methodology in determining whether a particular security is impaired. Under the methodology, the Group will not only take into consideration the mark-to-market (MTM) price of the issue and its external credit rating, but also other factors including the FICO score, vintage, location, adjustable rate mortgage ("ARM") status, delinquencies, level of collateral protection, loan to value ratio and prepayment speed of the underlying assets. Having considered these factors, the ABS/MBS issue has to further pass the required credit enhancement coverage ratio set by the Group. This ratio is determined by applying assumptions regarding the default rates based on the available delinquency, foreclosure and real estate owned ("REO") data of the ABS/MBS issue.

The methodology and assumptions used for the assessments are reviewed regularly. In evaluating impairment of ABS/MBS during the year, the Group continued to consider a significant decline in market prices of ABS/MBS to be a key indicator of impairment. In addition, due to reduced market liquidity and wider dispersion in indicative prices of certain ABS/MBS held by the Group, the Group also ensured that there was additional objective evidence of credit impairment by considering whether there has been a significant adverse change in the credit enhancement coverage ratio, taking into account the reported delinquencies and credit losses incurred in the underlying mortgage portfolio for each security held by the Group.

Many of the ABS/MBS held by the Group are complex, and involve cashflows over many years. These future cashflows depend on economic factors such as US residential real estate prices and the performance of the US economy. The recoverable amounts of the securities therefore cannot be predicted with certainty at the current balance sheet date, and additional impairment charges – or releases of impairment charges – may be required in future accounting periods.

3.3 Fair values of derivatives financial instruments

The fair values of derivatives financial instruments that are not quoted in active markets are determined by using valuation techniques. Valuation techniques used include discounted cash flows analysis and models with built-in functions available in externally acquired financial analysis or risk management systems widely used by the industry. To the extent practical, the models use only observable data.

3.4 Fair value of structured investment vehicle

One of the Group's non-banking subsidiaries has invested in a structured investment vehicle managed by a third party portfolio manager, which is included in the Group's investment portfolio classified as financial assets at fair value through profit or loss. As there is no active market for this investment, management has assessed the fair value with reference to valuation received from the third party portfolio manager. As at 31 December 2008, the net carrying amount of this investment in the structured investment vehicle was approximately HK$57 million (2007: approximately HK$100 million).

3.5 Held-to-maturity investments

The Group follows the guidance of HKAS 39 in classifying certain non-derivative financial assets with fixed or determinable payments and fixed maturity as held-to-maturity. This classification requires significant judgement. In making this judgement, the Group evaluates its intention and ability to hold such investments to maturity. If the Group fails to hold these investments to maturity other than for specific circumstances defined in HKAS 39, such as selling an insignificant amount close to maturity, it will be required to reclassify the entire portfolio of assets as available-for-sale. The investments would then be measured at fair value and not amortised cost.

3. Critical accounting estimates and judgements in applying accounting policies (continued)

3.6 Estimate of future benefit payments and premiums arising from long term insurance contracts

In determining the Group's long term business fund liabilities under insurance contracts, the Group follows the Insurance Companies Ordinance (Determination of Long Term Liabilities) Regulation and makes prudent assumptions which include appropriate margins for adverse deviation of the relevant factors. Estimates are made as to the expected number of deaths for each of the years in which the Group is exposed to risk. The Group bases these estimates on standard industry and Hong Kong Assured Lives Mortality Table HKA01 that reflect recent historical mortality experience, adjusted where appropriate to reflect the Group's own experience. For contracts that insure the risk of longevity, appropriate prudent allowances are made for expected mortality improvements. The estimated number of deaths determines the value of the benefit payments and the value of the valuation premiums. The main source of uncertainty is that epidemics such as AIDS, SARS, avian flu and wide-ranging lifestyle changes, such as in eating, smoking and exercise habits, could result in future mortality being significantly worse than in the past for the age groups in which the Group has significant exposure to mortality risk. However, continuing improvements in medical care and social conditions could result in improvements in longevity in excess of those allowed for in the estimates used to determine the liability for contracts where the Group is exposed to longevity risk.

Were the number of deaths in future years to differ by 10% from management's estimate, the long term business fund liability would increase by approximately HK$106 million (2007: HK$72.6 million), which accounts for 0.39% (2007: 0.36%) of the liability. In this case, it is assumed there is no relief arising from reinsurance contracts held.

For linked long term insurance contracts with a life cover component, it is assumed that the Group will be able to increase mortality risk charges in future years in line with emerging mortality experience.

Estimates are also made as to future investment income arising from the assets backing long term insurance contracts. These estimates are based on current market returns as well as expectations about future economic and financial developments. Were the average future investment returns to decrease by 50 basis points from management's estimates, the long term business fund liability would increase by approximately HK$998 million (2007: approximately HK$1,009 million). In this case, there is no relief arising from reinsurance contracts held.

The Group has also assessed whether a provision for expense is necessary in accordance with the Insurance Companies Ordinance. A provision for expense is the amount to meet the total net cost that would likely be incurred in fulfilling contracts if the Group were to cease to transact new business 12 months after the valuation date. In the calculation of expense reserve, the Group has assumed it will carry on selling new business rather than ceases in 12 months period.

A resilience reserve was set up and included in long term business fund liabilities in accordance with the Insurance Companies Ordinance (Determination of Long Term Liabilities) Regulations to provide a prudent provision against the effects of possible future changes to the value of the assets to meet the liabilities. The resilience reserve was set up based on the appointed actuary advice of a 15 basis points (2007: 50 basis points) change in market yield of the underlying assets and valuation interest rates. The amount of resilience reserve to be set up depends on the degree of change in interest rate assumed.

3.7 Provision

The Group uses judgment to assess whether the Group has a present legal or constructive obligation as a result of past events at each balance sheet date, and judgment is used to determine if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and to determine a reliable estimate of the amount of the obligation.

4. Financial risk management

The Group is exposed to financial risks as a result of engaging in a variety of business activities. The principal financial risks are credit risk, market risk (including currency risk and interest rate risk) and liquidity risk. This note summarises the Group's exposures to these risks, as well as its objectives, policies and processes for managing and the methods used to measure these risks.

Financial risk management framework

The Group's management governance structure is designed to cover all business processes and ensure various risks are properly managed and controlled in the course of conducting business. The Group has a robust risk management organisational structure with a comprehensive set of policies and procedures to identify, measure, monitor and control various risks that may arise. These risk management policies and procedures are regularly reviewed and modified to reflect changes in markets and business strategies. Various groups of risk takers assume their respective responsibilities for risk management.

The Board of Directors, representing the interests of shareholders, is the highest decision making authority of the Group and has the ultimate responsibility for risk management. The Board, with the assistance of the Risk Committee, has the primary responsibility for the formulation of risk management strategies and for ensuring that the Group has an effective risk management system to implement these strategies.

The Risk Committee ("RC"), a standing committee established by the Board of Directors, is responsible for overseeing the Group's various types of risks, reviewing and approving high-level risk-related policies and overseeing their implementation, reviewing significant or high risk exposures or transactions and exercising its power of veto if it considers that any transaction should not proceed.

The Chief Executive ("CE") is responsible for managing the Group's various types of risks, approving detailed risk management policies, and approving material risk exposures or transactions within his authority delegated by the Board of Directors. The Chief Risk Officer ("CRO") assists the CE in fulfilling his responsibilities for the day-to-day management of risks. The CRO is responsible for initiating new risk management strategies, projects and measures that will enable the Group to better monitor and manage new risk issues or areas that may arise from time to time from new businesses, products and changes in the operating environment. He may also take appropriate initiatives in response to regulatory changes. The CRO is also responsible for reviewing material risk exposures or transactions within his delegated authority and exercising his power of veto if he believes that any transaction should not proceed.

The Group has put in place appropriate internal control systems, including establishment of an organisation structure that sets adequately clear lines of authority and responsibility for monitoring compliance with policies, procedures and limits. Proper reporting lines also provide sufficient independence of the control functions from the business areas, as well as adequate segregation of duties throughout the organisation which helps to promote an appropriate internal control environment.

Product development

To ensure effective risk assessment and monitoring, the Group developed a comprehensive product development and management framework which clearly defines the roles and responsibilities of all related units, and the proper risk assessment procedures for the product development process.

In accordance with the strategic objectives set by the Management, the respective product management units are responsible for formulating business and product development plans, and the department of strategic development shall ensure the plans are aligned with the Bank's overall strategies. Departments that are responsible for risk management, legal and compliance and finance etc. are accountable for risk assessment and review.

Apart from product development, the respective business units shall work closely with relevant risk evaluating departments to identify and assess all the related risks. Based on the consideration of segregation of duties, risk evaluating departments shall conduct independent review on risk management procedures and assessment results. Products can only be launched after the risk management procedures are fulfilled and endorsed by all risk evaluating departments.

4. Financial risk management (continued)

4.1 Credit Risk

Credit risk is the risk that a customer or counterparty will be unable to or unwilling to meet its obligations under a contract. It arises principally from lending, trade finance and treasury businesses including inter-bank transactions, investments in bonds and securities.

Credit risk management framework

The Group has formulated a comprehensive set of credit risk management policies and procedures, and appropriate credit risk limits to manage and control credit risk that may arise. These policies, procedures and credit risk limits are regularly reviewed to cope with changes in market conditions and business strategies.

The Group's organisation structure establishes a clear set of authority and responsibility for monitoring compliance with policies, procedures and limits.

The Chief Credit Officer ("CCO") reports directly to the CRO and is responsible for the management of credit risk and for the formulation of all credit policies and procedures. Various units of the Group have their respective credit risk management responsibilities. Business units act as the first line of defense while risk management units, which are independent from the business units, are responsible for the day-to-day management of credit risks. The Risk Management Department ("RMD") has the primary responsibility for drafting, reviewing and updating credit risk management policies and procedures. The Group's principal banking subsidiaries, Nanyang, Nanyang (China), and Chiyu, have also formulated their own credit risk policies that are consistent with those of the Group. These subsidiaries execute their risk management strategies independently and report to the Group's management on a regular basis.

The Board of Directors delegates credit approval authority to the CE. The CE can further delegate to the subordinates within his limit authorised by the Board of Directors. The Group sets the limits of credit approval authority according to the business nature, rating, the level of transaction risk, and the extent of the credit exposure.

Credit risk measurement and control

In view of the rapidly changing market conditions since the outbreak of the Subprime crisis, the Bank has been continuously revisiting its lending strategies and conducting rigorous reviews on the concerned portfolios.

<u>Loans and advances</u>

Different credit approval and control procedures are adopted according to the level of risk associated with the customer, counterparty or transaction. Corporate and financial institution credit applications are independently reviewed, objectively assessed and monitored by risk management units. A small business credit scorecard as a supplemental tool is used to assist the credit assessment of small enterprise credit facilities. A credit scoring system is used to process retail credit transactions, including residential mortgage loans, personal loans and credit cards while a bank scorecard is used to assist the risk assessment of financial institutions' credit risk. The Credit Risk Assessment Committee comprising experts from the Group's credit and other functions is responsible for making an independent assessment of all credit facilities which require the approval of Deputy Chief Executives or above.

RMD provides regular credit management information reports and ad hoc reports to the Management Committee ("MC"), RC and Board of Directors to facilitate their continuous monitoring of credit risk.

The Group identifies credit concentration risk by industry, geography, customer and counterparty risk. The Group monitors changes to counterparties credit risk, quality of the credit portfolio and risk concentrations, and reports regularly to the Group's management.

The Group's internal loan grading system divides credit assets into 5 categories with reference to HKMA's guidelines.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Credit risk measurement and control (continued)

Loans and advances (continued)

"Pass" represents loans where the borrower is current in meeting its repayment obligations and full repayment of interest and principal is not in doubt.

"Special Mention" represents loans where the borrowers are experiencing difficulties which may threaten the Group's position. Ultimate loss is not expected at this stage but could occur if adverse conditions persist.

"Substandard" represents loans where the borrower displays a definable weakness that is likely to jeopardise repayment.

"Doubtful" represents loans where collection in full is improbable and the Group expects to sustain a loss of principal and/or interest, taking into account the net realisable value of the collateral.

"Loss" represents loans which are considered uncollectible after all collection options (such as the realisation of collateral or the institution of legal proceedings) have been exhausted.

Debt securities and derivatives

For investments in debt securities and securitisation assets, the external credit rating and assessment on credit quality of the underlying assets are used for managing the credit risk involved. Credit limits are established on a customer and security issuer basis. For derivatives, the Group sets customer limits to manage the credit risk involved and follows the same approval and control processes as loans and advances. On-going monitoring procedures are established.

The Group adopts a comprehensive methodology in determining whether a particular asset/mortgage backed security ("ABS/MBS") is impaired. Under the methodology, the Group will not only take into consideration the mark-to-market (MTM) price of the issue and its external credit rating, but also other factors including the FICO score, vintage, location, adjustable rate mortgage ("ARM") status, delinquencies, level of collateral protection, loan to value ratio and prepayment speed of the underlying assets. Having considered these factors, the ABS/MBS issue has to further pass the required credit enhancement coverage ratio set by the Group. This ratio is determined by applying assumptions regarding the default rates based on the available delinquency, foreclosure and real estate owned ("REO") data of the ABS/MBS issue.

Settlement risk arises mainly from foreign exchange transactions with counterparties and also from derivatives 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 Group's market transactions on any single day.

Collateral held as security and other credit enhancements

The valuation and management of collateral have been documented in the policy covering acceptance criteria, validity of collateral, loan-to-value ratio, haircut ratio, valuation and insurance, etc. The collateral is revalued on a regular basis, though the frequency and the method used varies with the type of collateral involved and the nature and the risk of the underlying credit. The Group has established a mechanism to update the value of its main type of collateral, real properties, with the use of public indices on a portfolio basis. Collateral is insured with the Group as the beneficiary. In the personal sector, the main types of collateral are real properties, cash deposits, securities and investment funds. In the commercial and industrial sector, the main types of collateral are real properties, securities, receivables, cash deposits and machinery.

For loans guaranteed by a third party guarantor, the Group will assess the guarantor's financial condition, credit history and ability to meet obligations.

As at 31 December 2008 and 2007, the Group did not hold any collateral permitted to sell or re-pledge in the absence of default by the borrower.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Credit exposures

Maximum exposures to credit risk before collateral held or other credit enhancements are summarised as follows:

	2008 HK$'m	2007 HK$'m
Credit risk exposures relating to on-balance sheet assets are as follows:		
Cash and balances with banks and other financial institutions	**153,269**	159,065
Placements with banks and other financial institutions maturing between 1 and 12 months	**89,718**	53,154
Financial assets at fair value through profit or loss – debt securities	**41,438**	30,856
Derivative financial instruments	**19,628**	14,477
Hong Kong SAR Government certificates of indebtedness	**34,200**	32,770
Advances and other accounts	**469,493**	420,234
Investment in securities		
– debt securities – available-for-sale	**170,935**	100,073
– debt securities – held-to-maturity	**106,465**	165,428
– debt securities – loans and receivables	**12,595**	31,102
Other assets	**13,332**	20,857
Credit risk exposures relating to off-balance sheet items are as follows:		
Letters of guarantee issued	**11,838**	9,407
Loan commitment and other credit related liabilities	**241,551**	221,896
	1,364,462	1,259,319

Gross loans and advances

Gross loans and advances before loan impairment allowances are summarised by product type as follows:

	2008 HK$'m	2007 HK$'m
Advances to customers		
Personal		
– Mortgages	**130,980**	121,663
– Credit cards	**6,445**	5,641
– Others	**14,359**	14,404
Corporate		
– Commercial loans	**284,108**	247,079
– Trade finance	**24,555**	24,275
	460,447	413,062
Trade bills	**7,609**	5,334
Advances to banks and other financial institutions	**3,738**	3,223
Total	**471,794**	421,619

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

Advances with a specific repayment date are classified as overdue when the principal or interest is past due and remains unpaid. Advances repayable by regular instalments are classified as overdue when an instalment payment is past due and remains unpaid. Advances repayable on demand are classified as overdue either when a demand for repayment has been served on the borrower but repayment has not been made in accordance with the instruction or when the advances have remained continuously outside the approved limit that was advised to the borrower.

A financial asset is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred and that loss event(s) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

If there is objective evidence that an impairment loss on loans has been incurred, the amount of loss is measured as the difference between the carrying amount and the present value of estimated future cash flows generated by the financial asset. Objective evidence that a financial asset is impaired includes observable data that comes to the attention of the holder of the asset about the loss events.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss include:

– Significant financial difficulty incurred by the borrower;

– A breach of contract, such as a default or delinquency in interest or principal payment;

– For economic or legal reasons related to the borrower's financial difficulty, the Group has granted to the borrower a concession that it would not otherwise consider;

– Probable that the borrower will become bankrupt or undergo other financial reorganisation; or

– Other observable data indicating that there is a measurable decrease in the estimated future cash flows from such loans and advances.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(a) Advances neither overdue nor impaired

Advances that were neither overdue nor impaired are analysed by internal credit grades as follows:

	2008			
	Pass HK$'m	**Special mention HK$'m**	**Substandard or below HK$'m**	**Total HK$'m**
Advances to customers				
Personal				
– Mortgages	**128,545**	**155**	**88**	**128,788**
– Credit cards	**6,179**	**–**	**–**	**6,179**
– Others	**13,839**	**75**	**10**	**13,924**
Corporate				
– Commercial loans	**275,844**	**6,349**	**274**	**282,467**
– Trade finance	**23,381**	**538**	**5**	**23,924**
	447,788	**7,117**	**377**	**455,282**
Trade bills	**7,084**	**523**	**2**	**7,609**
Advances to banks and other financial institutions	**3,738**	**–**	**–**	**3,738**
Total	**458,610**	**7,640**	**379**	**466,629**

	2007			
	Pass HK$'m	Special mention HK$'m	Substandard or below HK$'m	Total HK$'m
Advances to customers				
Personal				
– Mortgages	118,583	229	112	118,924
– Credit cards	5,397	–	–	5,397
– Others	13,737	78	20	13,835
Corporate				
– Commercial loans	243,140	908	349	244,397
– Trade finance	23,052	795	4	23,851
	403,909	2,010	485	406,404
Trade bills	5,255	74	1	5,330
Advances to banks and other financial institutions	3,223	–	–	3,223
Total	412,387	2,084	486	414,957

The occurrence of loss event(s) may not necessarily result in impairment loss where the loans are fully collateralised. While such loans are of "substandard" or lower grades, they are regarded as not being impaired and have been included in the above table.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(b) Advances overdue but not impaired

The gross amount of advances overdue but not impaired is analysed as follows:

	2008					
	Overdue for 3 months or less HK$'m	**Overdue for 6 months or less but over 3 months HK$'m**	**Overdue for 1 year or less but over 6 months HK$'m**	**Overdue for over 1 year HK$'m**	**Total HK$'m**	**Market value of collateral HK$'m**
Advances to customers						
Personal						
– Mortgages	**2,065**	**34**	**12**	**30**	**2,141**	**4,870**
– Credit cards	**237**	**–**	**–**	**–**	**237**	**–**
– Others	**318**	**3**	**3**	**32**	**356**	**731**
Corporate						
– Commercial loans	**832**	**8**	**9**	**156**	**1,005**	**2,437**
– Trade finance	**81**	**4**	**–**	**15**	**100**	**178**
Total	**3,533**	**49**	**24**	**233**	**3,839**	**8,216**

	2007					
	Overdue for 3 months or less HK$'m	Overdue for 6 months or less but over 3 months HK$'m	Overdue for 1 year or less but over 6 months HK$'m	Overdue for over 1 year HK$'m	Total HK$'m	Market value of collateral HK$'m
Advances to customers						
Personal						
– Mortgages	2,465	77	45	48	2,635	5,634
– Credit cards	221	–	–	–	221	–
– Others	428	3	12	31	474	875
Corporate						
– Commercial loans	1,997	54	42	203	2,296	4,509
– Trade finance	315	7	2	11	335	410
	5,426	141	101	293	5,961	11,428
Trade bills	4	–	–	–	4	–
Total	5,430	141	101	293	5,965	11,428

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(b) Advances overdue but not impaired (continued)

	2008 HK$'m	2007 HK$'m
Current market value of collateral held against the covered portion of advances to customers	**8,216**	11,428
Covered portion of advances to customers	**3,341**	4,929
Uncovered portion of advances to customers	**498**	1,032

(c) Impaired advances

Advances individually identified to be impaired are analysed by product type as follows:

	2008		2007	
	Gross advances HK$'m	**Market value of collateral HK$'m**	Gross advances HK$'m	Market value of collateral HK$'m
Advances to customers				
Personal				
– Mortgages	**51**	**50**	104	95
– Credit cards	**29**	**–**	23	–
– Others	**79**	**21**	95	54
Corporate				
– Commercial loans	**636**	**434**	386	392
– Trade finance	**531**	**205**	89	18
Total	**1,326**	**710**	697	559
Loan impairment allowances made in respect of such advances	**829**		403	

The loan impairment allowances were made after taking into account the value of collateral in respect of impaired advances.

	2008 HK$'m	2007 HK$'m
Current market value of collateral held against the covered portion of advances to customers	**710**	559
Covered portion of advances to customers	**628**	410
Uncovered portion of advances to customers	**698**	287

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(c) Impaired advances (continued)

Classified or impaired advances to customers are analysed as follows:

	2008 HK$'m	2007 HK$'m
Gross classified or impaired advances to customers	**2,138**	1,803
Gross classified or impaired advances to customers as a percentage of gross advances to customers	**0.46%**	0.44%
Individually assessed loan impairment allowances made in respect of such advances	**800**	381

Classified or impaired advances to customers follow the definitions set out in the Banking (Disclosure) Rules and represent advances which are either classified as "substandard", "doubtful" or "loss" under the Group's classification of loan quality, or individually assessed to be impaired.

(d) Advances overdue for more than 3 months

The gross amount of advances overdue for more than 3 months is analysed as follows:

	2008		2007	
	Amount HK$'m	**% of gross advances to customers**	Amount HK$'m	% of gross advances to customers
Gross advances to customers which have been overdue for:				
– six months or less but over three months	**339**	**0.07%**	242	0.06%
– one year or less but over six months	**66**	**0.02%**	163	0.04%
– over one year	**571**	**0.12%**	652	0.16%
Advances overdue for over three months	**976**	**0.21%**	1,057	0.26%
Individually assessed loan impairment allowances made in respect of such advances	**439**		305	

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(d) Advances overdue for more than 3 months (continued)

	2008 HK$'m	2007 HK$'m
Current market value of collateral held against the covered portion of advances to customers	**1,436**	1,970
Covered portion of advances to customers	**604**	847
Uncovered portion of advances to customers	**372**	210

Collateral held against overdue or impaired loans is principally represented by charges over business assets such as commercial and residential premises for corporate loans and mortgages over residential properties for personal loans.

As at 31 December 2008 and 2007, there were no advances to banks and other financial institutions overdue for more than three months.

(e) Rescheduled advances

	2008		2007	
	Amount HK$'m	**% of gross advances to customers**	Amount HK$'m	% of gross advances to customers
Rescheduled advances to customers net of amounts included in advances overdue for more than 3 months	**127**	**0.03%**	186	0.05%

As at 31 December 2008, the total rescheduled advances to customers during the year amounted to HK$54 million (2007: HK$88 million).

As at 31 December 2008 and 2007, there were no rescheduled advances to banks and other financial institutions.

Rescheduled advances are those advances that have been restructured or renegotiated because of deterioration in the financial position of the borrower or of the inability of the borrower to meet the original repayment schedule and for which the revised repayment terms, either of interest or of repayment period, are non-commercial. Rescheduled advances, which have been overdue for more than three months under the revised repayment terms, are included in overdue advances.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(f) Concentration of advances to customers

(i) Sectoral analysis of gross advances to customers

The information concerning gross advances to customers has been analysed into loans used inside or outside Hong Kong by industry sectors of the borrowers as follows:

	2008					
	Gross advances HK$'m	% Covered by collateral or other security	Classified or impaired HK$'m	Overdue* HK$'m	Individually assessed impairment allowances HK$'m	Collectively assessed impairment allowances HK$'m
Loans for use in Hong Kong						
Industrial, commercial and financial						
– Property development	19,856	40.49%	2	14	1	66
– Property investment	71,374	88.00%	294	585	30	312
– Financial concerns	11,547	8.63%	–	–	1	56
– Stockbrokers	124	10.33%	–	–	–	–
– Wholesale and retail trade	18,156	52.85%	218	300	71	98
– Manufacturing	16,410	53.67%	234	298	138	80
– Transport and transport equipment	21,590	13.82%	2	9	1	81
– Recreational activities	139	46.87%	–	–	–	–
– Information technology	6,049	2.21%	–	3	–	19
– Others	23,529	26.91%	68	213	13	83
Individuals						
– Loans for the purchase of flats in Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	13,477	99.91%	98	510	4	12
– Loans for purchase of other residential properties	116,303	99.97%	153	1,650	7	74
– Credit card advances	6,553	–	30	273	–	71
– Others	11,490	77.92%	107	333	57	20
Total loans for use in Hong Kong	336,597	70.84%	1,206	4,188	323	972
Trade finance	24,555	30.36%	560	494	355	108
Loans for use outside Hong Kong	99,295	22.38%	372	235	122	421
Gross advances to customers	460,447	58.23%	2,138	4,917	800	1,501

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(f) Concentration of advances to customers (continued)

(i) Sectoral analysis of gross advances to customers (continued)

	2007					
	Gross advances HK$'m	% Covered by collateral or other security	Classified or impaired HK$'m	Overdue* HK$'m	Individually assessed impairment allowances HK$'m	Collectively assessed impairment allowances HK$'m
Loans for use in Hong Kong						
Industrial, commercial and financial						
– Property development	17,979	33.97%	16	18	3	52
– Property investment	65,963	86.50%	343	961	14	187
– Financial concerns	12,346	6.05%	–	14	–	43
– Stockbrokers	242	12.10%	–	–	–	–
– Wholesale and retail trade	13,572	65.05%	238	382	85	41
– Manufacturing	14,468	58.08%	138	550	37	48
– Transport and transport equipment	21,001	21.11%	3	25	1	60
– Recreational activities	30	93.53%	–	–	–	–
– Information technology	2,009	37.39%	–	2	–	6
– Others	21,046	41.70%	90	584	16	65
Individuals						
– Loans for the purchase of flats in Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	13,969	99.78%	129	599	8	13
– Loans for purchase of other residential properties	106,583	99.87%	284	2,078	18	81
– Credit card advances	5,761	–	23	245	–	63
– Others	10,708	79.61%	119	314	50	14
Total loans for use in Hong Kong	305,677	73.31%	1,383	5,772	232	673
Trade finance	24,275	40.71%	105	399	73	77
Loans for use outside Hong Kong	83,110	39.76%	315	375	76	254
Gross advances to customers	413,062	64.64%	1,803	6,546	381	1,004

* Advances with a specific repayment date are classified as overdue when the principal or interest is past due and remains unpaid.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(f) Concentration of advances to customers (continued)

(i) Sectoral analysis of gross advances to customers (continued)

The amount of new impairment allowances charged to the income statement, and classified or impaired loans written off during the year are shown below:

	2008		2007	
	New impairment allowances HK$'m	Classified or impaired loans written off HK$'m	New impairment allowances HK$'m	Classified or impaired loans written off HK$'m
Loans for use in Hong Kong				
Industrial, commercial and financial				
– Property development	28	–	25	–
– Property investment	139	5	99	9
– Financial concerns	24	–	22	–
– Stockbrokers	–	–	–	–
– Wholesale and retail trade	120	103	149	98
– Manufacturing	249	125	58	18
– Transport and transport equipment	34	–	31	–
– Recreational activities	–	–	–	–
– Information technology	9	–	3	–
– Others	34	8	77	5
Individuals				
– Loans for the purchase of flats in Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	1	1	13	4
– Loans for purchase of other residential properties	8	–	79	1
– Credit card advances	157	141	124	126
– Others	61	47	50	50
Total loans for use in Hong Kong	864	430	730	311
Trade finance	374	26	76	15
Loans for use outside Hong Kong	266	19	149	1
Gross advances to customers	1,504	475	955	327

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(f) Concentration of advances to customers (continued)

(ii) Geographical analysis of gross advances to customers and overdue advances

The following geographical analysis of gross advances to customers and overdue advances is based on the location of the counterparties, after taking into account the transfer of risk in respect of such advances where appropriate.

Gross advances to customers

	2008 **HK$'m**	2007 HK$'m
Hong Kong	**374,506**	351,102
Mainland China	**55,318**	39,050
Others	**30,623**	22,910
	460,447	413,062
Collectively assessed loan impairment allowances in respect of the gross advances to customers		
Hong Kong	**1,172**	827
Mainland China	**221**	124
Others	**108**	53
	1,501	1,004

Overdue advances

	2008 **HK$'m**	2007 HK$'m
Hong Kong	**4,622**	6,221
Mainland China	**266**	278
Others	**29**	47
	4,917	6,546
Individually assessed loan impairment allowances in respect of the overdue advances		
Hong Kong	**554**	284
Mainland China	**99**	46
Others	**21**	2
	674	332
Collectively assessed loan impairment allowances in respect of the overdue advances		
Hong Kong	**50**	60
Mainland China	**6**	10
	56	70

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Gross loans and advances (continued)

(f) Concentration of advances to customers (continued)

(ii) Geographical analysis of gross advances to customers and overdue advances (continued)

Classified or impaired advances

	2008 HK$'m	2007 HK$'m
Hong Kong	**1,792**	1,572
Mainland China	**323**	223
Others	**23**	8
	2,138	1,803
Individually assessed loan impairment allowances in respect of the classified or impaired advances		
Hong Kong	**677**	333
Mainland China	**100**	46
Others	**23**	2
	800	381
Collectively assessed loan impairment allowances in respect of the classified or impaired advances		
Hong Kong	**26**	19
Mainland China	**7**	6
	33	25

Repossessed assets

During the year, the Group obtained assets by taking possession of collateral held as security. The nature and carrying value of such assets are summarised as follows:

	2008 HK$'m	2007 HK$'m
Commercial properties	**18**	10
Residential properties	**85**	43
	103	53

The estimated market value of repossessed assets held by the Group as at 31 December 2008 amounted to HK$173 million (2007: HK$116 million). They comprise properties in respect of which the Group has acquired access or control (e.g. through court proceedings or voluntary actions by the borrowers concerned) for release in full or in part of the obligations of the borrowers.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Repossessed assets (continued)

When the repossessed assets are not readily convertible into cash, the Group may consider the following alternatives:

– adjusting the selling prices

– selling the loans together with the assets

– arranging loan restructuring

Balances and placements with banks and other financial institutions

The following table presents an analysis of balances and placements with banks and other financial institutions that are neither overdue nor impaired as at 31 December by rating agency designation, based on Moody's ratings or their equivalent.

	2008			
	Aaa to A3 HK$'m	**Lower than A3 HK$'m**	**Unrated HK$'m**	**Total HK$'m**
Central banks	**66,158**	**–**	**–**	**66,158**
Banks and other financial institutions	**168,456**	**586**	**3,555**	**172,597**
	234,614	**586**	**3,555**	**238,755**

	2007			
	Aaa to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m
Central banks	30,627	–	–	30,627
Banks and other financial institutions	173,248	2,047	2,963	178,258
	203,875	2,047	2,963	208,885

As at 31 December 2008 and 2007, there were no overdue or impaired balances and placements with banks and other financial institutions.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities

The table below represents an analysis of the carrying value of debt securities by credit rating and credit risk characteristic, based on Moody's ratings or their equivalent to the respective issues of the debt securities.

	2008							
					Unrated			
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Hong Kong government and government bodies HK$'m	Other governments and government agencies HK$'m	Other HK$'m	Total HK$'m
Investment in securities								
US non-agency residential mortgage-backed								
– Subprime	913	–	30	104	–	–	–	1,047
– Alt-A	1,245	383	274	432	–	–	–	2,334
– Prime	9,549	1,558	2,878	1,950	–	–	–	15,935
Fannie Mae								
– issued debt securities	1,504	–	–	–	–	–	–	1,504
– mortgage-backed securities	–	–	–	–	–	88	–	88
Freddie Mac								
– issued debt securities	864	162	–	–	–	–	–	1,026
– mortgage-backed securities	–	–	–	–	–	1,633	–	1,633
Other MBS/ABS	6,874	24	63	–	–	3,807	–	10,768
Other debt securities	40,537	83,827	27,509	4,371	12,175	51,368	35,873	255,660
Subtotal	61,486	85,954	30,754	6,857	12,175	56,896	35,873	289,995
Financial assets at fair value through profit or loss								
Fannie Mae								
– issued debt securities	287	–	–	–	–	–	–	287
Other MBS/ABS	27	–	–	–	–	–	–	27
Other debt securities	2,304	15,417	10,233	1,457	11,358	–	355	41,124
Subtotal	2,618	15,417	10,233	1,457	11,358	–	355	41,438
Total	64,104	101,371	40,987	8,314	23,533	56,896	36,228	331,433

Note: In 2007, securities issued by Ginnie Mae of HK$3,365 million were disclosed as Aaa rating, whereas for the current year such securities of HK$3,807 million have been included in above as "Unrated – Other governments and government agencies".

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

	2007							
					Unrated			
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Hong Kong government and government bodies HK$'m	Other governments and government agencies HK$'m	Other HK$'m	Total HK$'m
Investment in securities								
US non-agency residential mortgage-backed								
– Subprime	4,118	–	–	–	–	–	–	4,118
– Alt-A	6,567	–	–	–	–	–	–	6,567
– Prime	29,014	–	–	–	–	–	–	29,014
Fannie Mae								
– issued debt securities	4,243	–	–	–	–	–	–	4,243
– mortgage-backed securities	–	–	–	–	–	104	–	104
Freddie Mac								
– issued debt securities	2,753	165	–	–	–	–	–	2,918
– mortgage-backed securities	–	–	–	–	–	1,683	–	1,683
Other MBS/ABS	14,105	78	–	–	–	–	139	14,322
Other debt securities	33,572	88,709	27,062	2,772	6,946	–	74,573	233,634
Subtotal	94,372	88,952	27,062	2,772	6,946	1,787	74,712	296,603
Financial assets at fair value through profit or loss								
Fannie Mae								
– issued debt securities	268	–	–	–	–	–	–	268
Other MBS/ABS	40	–	–	–	–	–	–	40
Other debt securities	2,986	12,238	7,370	1,136	3,518	–	3,300	30,548
Subtotal	3,294	12,238	7,370	1,136	3,518	–	3,300	30,856
Total	97,666	101,190	34,432	3,908	10,464	1,787	78,012	327,459

The total amount of unrated issues amounted to HK$116,657 million (2007: HK$90,263 million) as at 31 December 2008, of which only HK$8,975 million (2007: HK$10,672 million) were without issuer ratings. For details, please refer to page 140.

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

For the above debt securities with no issue rating, their issuer ratings are analysed as follows:

	2008					
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m
Available-for-sale securities	**18,180**	**49,408**	**3,293**	**35**	**5,481**	**76,397**
Held-to-maturity securities	**624**	**10,140**	**2,037**	**–**	**3,151**	**15,952**
Loans and receivables	**3,386**	**8,768**	**397**	**–**	**44**	**12,595**
Financial assets at fair value through profit or loss	**1**	**11,413**	**–**	**–**	**299**	**11,713**
Total	**22,191**	**79,729**	**5,727**	**35**	**8,975**	**116,657**

	2007					
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m
Available-for-sale securities	2,486	8,166	3,818	440	1,708	16,618
Held-to-maturity securities	5,859	20,467	3,765	50	5,584	35,725
Loans and receivables	8,572	19,365	80	–	3,085	31,102
Financial assets at fair value through profit or loss	29	4,234	2,085	175	295	6,818
Total	16,946	52,232	9,748	665	10,672	90,263

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

The following table presents an analysis of debt securities neither overdue nor impaired as at 31 December by rating agency designation, based on Moody's ratings or their equivalent to the respective issues of the debt securities.

	2008					
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m
Available-for-sale securities	32,231	41,722	12,752	1,839	76,362	164,906
Held-to-maturity securities	22,667	42,554	16,201	2,067	15,952	99,441
Loans and receivables	–	–	–	–	12,595	12,595
Financial assets at fair value through profit or loss	2,618	15,417	10,233	1,457	11,709	41,434
Total	57,516	99,693	39,186	5,363	116,618	318,376

	2007					
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m
Available-for-sale securities	42,166	28,588	10,686	1,459	16,618	99,517
Held-to-maturity securities	47,912	60,364	16,376	1,313	35,725	161,690
Loans and receivables	–	–	–	–	31,102	31,102
Financial assets at fair value through profit or loss	3,294	12,238	7,370	1,136	6,818	30,856
Total	93,372	101,190	34,432	3,908	90,263	323,165

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

The carrying values of impaired debt securities by credit rating are analysed as follows:

	2008						
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m	Of which impairment allowances HK$'m
Available-for-sale securities	3,451	814	542	1,187	35	6,029	4,561
Held-to-maturity securities	3,137	864	1,259	1,764	–	7,024	4,440
Total	6,588	1,678	1,801	2,951	35	13,053	9,001
Of which impairment allowances	4,195	1,400	976	2,078	352	9,001	

	2007						
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m	Of which impairment allowances HK$'m
Available-for-sale securities	556	–	–	–	–	556	190
Held-to-maturity securities	3,738	–	–	–	–	3,738	1,682
Total	4,294	–	–	–	–	4,294	1,872
Of which impairment allowances	1,872	–	–	–	–	1,872	

Debt securities overdue but not impaired are analysed as follows:

	Overdue for 6 months or less but over 3 months	
	2008 HK$'m	2007 HK$'m
Financial assets at fair value through profit or loss	4	–

Note: Impairment is not measured for financial assets at fair value through profit or loss as assets are managed according to movements in fair value, and the fair value movement is taken directly to the income statement. Consequently, such overdue debt securities are reported under "overdue but not impaired".

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

Debt securities overdue for more than 3 months are analysed as follows:

	Overdue for 6 months or less but over 3 months	
	2008 HK$'m	2007 HK$'m
Available-for-sale securities	**35**	–
Financial assets at fair value through profit or loss	**4**	–
	39	–

MBS/ABS

The table below represents an analysis of the Group's exposure to MBS/ABS by geographical location.

	2008		
	Carrying values HK$'m	**Of which impaired HK$'m**	**Of which impairment allowances HK$'m**
US MBS/ABS			
Non-agency residential mortgage-backed			
– Subprime	**1,047**	**829**	**339**
– Alt-A	**2,334**	**1,750**	**1,302**
– Prime	**15,935**	**9,594**	**6,479**
Ginnie Mae	**3,807**	**–**	**–**
Fannie Mae	**88**	**–**	**–**
Freddie Mac	**1,633**	**–**	**–**
Commercial mortgage-backed	**929**	**–**	**–**
Others	**2,806**	**–**	**–**
	28,579	**12,173**	**8,120**
Other countries MBS/ABS			
Residential mortgage-backed	**2,649**	**69**	**27**
Commercial mortgage-backed	**454**	**–**	**–**
Others	**150**	**–**	**–**
	3,253	**69**	**27**
Total MBS/ABS	**31,832**	**12,242**	**8,147**

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

MBS/ABS (continued)

	2007		
	Carrying values HK$'m	Of which impaired HK$'m	Of which impairment allowances HK$'m
US MBS/ABS			
Non-agency residential mortgage-backed			
– Subprime	4,118	2,856	1,253
– Alt-A	6,567	1,380	573
– Prime	29,014	58	46
Ginnie Mae	3,365	–	–
Fannie Mae	104	–	–
Freddie Mac	1,683	–	–
Commercial mortgage-backed	997	–	–
Others	3,692	–	–
	49,540	4,294	1,872
Other countries MBS/ABS			
Residential mortgage-backed	5,189	–	–
Commercial mortgage-backed	561	–	–
Others	558	–	–
	6,308	–	–
Total MBS/ABS	55,848	4,294	1,872

	2008 HK$'m	2007 HK$'m
Fair value movement taken to available-for-sale reserve on MBS/ABS for the year (net of impairment charges taken to income statement excluding deferred tax impact)	**(1,340)**	(364)
Closing balance of available-for-sale reserve relating to MBS/ABS (excluding deferred tax impact)	**(1,707)**	(367)

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

MBS/ABS (continued)

The carrying values of impaired MBS/ABS by credit rating are analysed as follows:

	2008						
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m	Of which impairment allowances HK$'m
US MBS/ABS							
Non-agency residential mortgage-backed							
– Subprime	695	–	30	104	–	829	339
– Alt-A	662	383	274	431	–	1,750	1,302
– Prime	5,162	1,295	1,312	1,825	–	9,594	6,479
	6,519	1,678	1,616	2,360	–	12,173	8,120
Other countries MBS/ABS							
Residential mortgage-backed	69	–	–	–	–	69	27
Total MBS/ABS	6,588	1,678	1,616	2,360	–	12,242	8,147
Of which impairment allowances	4,195	1,400	938	1,614	–	8,147	

	2007						
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m	Of which impairment allowances HK$'m
US MBS/ABS							
Non-agency residential mortgage-backed							
– Subprime	2,856	–	–	–	–	2,856	1,253
– Alt-A	1,380	–	–	–	–	1,380	573
– Prime	58	–	–	–	–	58	46
Total MBS/ABS	4,294	–	–	–	–	4,294	1,872
Of which impairment allowances	1,872	–	–	–	–	1,872	

4. Financial risk management (continued)

4.1 Credit Risk (continued)

Debt securities (continued)

MBS/ABS (continued)

The table below represents an analysis of impairment charges for the year for MBS/ABS held as at 31 December.

	2008					
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m
US MBS/ABS						
Non-agency residential mortgage-backed						
– Subprime	(90)	–	27	27	–	(36)
– Alt-A	394	299	157	359	–	1,209
– Prime	3,725	1,055	658	1,094	–	6,532
	4,029	1,354	842	1,480	–	7,705
Other countries MBS/ABS						
Residential mortgage-backed	27	–	–	–	–	27
Total MBS/ABS	4,056	1,354	842	1,480	–	7,732

	2007					
	Aaa HK$'m	Aa1 to Aa3 HK$'m	A1 to A3 HK$'m	Lower than A3 HK$'m	Unrated HK$'m	Total HK$'m
US MBS/ABS						
Non-agency residential mortgage-backed						
– Subprime	1,253	–	–	–	–	1,253
– Alt-A	573	–	–	–	–	573
– Prime	46	–	–	–	–	46
Total MBS/ABS	1,872	–	–	–	–	1,872

4.2 Market Risk

Market risk is the risk of loss that results from movements in market rates and prices. The Group's market risk in trading book arises from trading positions taken from customer-related business and proprietary trading. These positions are subject to daily mark-to-market valuation. The risk includes potential losses arising from changes in foreign exchange and interest rates as well as equities and commodities prices. On the other hand, the major market risk in banking book arises from the group's investment portfolio. The risk includes potential losses arising from changes in market parameters such as credit, liquidity, and interest rate risk and price movements which prevent the Group from realising its investment securities at their carrying amounts. These positions are subject to monthly mark-to-market valuation. The Group manages market risk in its trading book separately from its banking book.

4. Financial risk management (continued)

4.2 Market Risk (continued)

Market risk management framework

The Group's risk management objective is to enhance shareholder value by maintaining risk exposures within acceptable limits. Market risk management framework of the Group comprises three levels. The Board of Directors and its Risk Committee are the ultimate decision making authorities. Formulation of the risk management procedures and implementation mechanism, and monitoring of the compliance are mainly responsible by senior management (including CE and CRO). RMD is responsible for the oversight of the Group's market risk to ensure that overall and individual market risks are within the Group's risk tolerance. Risk exposures are monitored on a day-to-day basis to ensure that they are within established risk limits and are regularly reported to the senior management. Nanyang, Chiyu and BOC Life have their own independent risk monitoring units to monitor limit compliance on a daily basis.

The Group's control of market risk is based on restricting individual operations to trading within various market risk limits approved by the RC, and a list of permissible instruments authorised by senior management, as well as enforcing rigorous new product approval procedures to ensure all risks arising are thoroughly identified, properly measured and adequately controlled.

Market risk arising from the trading book is managed within various major risk limits approved by the RC, including risk positions and/or risk factor sensitivities. Since April 2007 BOCHK has also formally applied Value-at-Risk (VAR) limit as a daily risk management tool. These overall risk limits are divided into sub-limits by reference to different risk products, including interest rate, foreign exchange rate, commodity price and equity products. Transactions are classified into different risk product categories according to the prominent type of risk inherent in the transactions.

The Group also uses the VAR technique to measure potential losses and market risks of its trading book for reporting to the RC and senior management on a periodic basis. VAR is a statistical technique which estimates the potential losses that could occur on risk positions taken over a specified time horizon within a given level of confidence. BOCHK, being the banking entity within the Group with the major trading positions, which are mainly foreign currency positions in major currencies, uses VAR technique to monitor and control market risk on a daily basis.

The Group has changed its VAR calculation from a variance/co-variance basis to historical simulation basis with effect from April 2007. The Group uses historical movements in market rates and prices, a 99% confidence level and a 1-day holding period to calculate portfolio and individual VAR. Movements in market prices are calculated by reference to market data from the last two years.

VAR

The following table sets out the VAR for all trading market risk exposure[1] of BOCHK.

HK$'m		At 31 December	Minimum for the year	Maximum for the year	Average for the year
VAR for all market risk	– 2008	12.6	3.0	13.5	6.5
	– 2007	3.2	1.4	10.4	4.1
VAR for foreign exchange risk products	– 2008	13.1	2.5	14.2	6.0
	– 2007	2.7	1.0	9.4	4.0
VAR for interest rate risk products	– 2008	4.2	1.0	5.9	2.9
	– 2007	1.5	0.5	3.9	1.6
VAR for equity risk products	– 2008	0.2	0.1	2.8	0.5
	– 2007	0.4	0.1	1.1	0.4
VAR for commodity risk products	– 2008	0.0	0.0	0.5	0.0
	– 2007	0.0	0.0	0.4	0.1

In 2008, the average daily revenue[2] of BOCHK earned from market risk-related trading activities was HK$5.35 million (2007: HK$3.06 million).

1 Structural FX positions have been excluded.

2 Revenues from structural FX positions and back to back transactions have been excluded.

4. Financial risk management (continued)

4.2 Market Risk (continued)

VAR (continued)

Predictive power of the VaR measure is monitored by backtesting, which compares the calculated VaR figure of those trading positions of each business day with the actual revenues arising on those positions on the next business day. These actual revenues exclude non-trading income including fees and commissions. If backtesting revenues are negative and exceed the VaR, a "backtesting exception" is noted. Backtesting results are reported to the Group's senior management, including CE and CRO.

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

– the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;

– the use of a one-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;

– the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and

– VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

The Group recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures.

Additionally, the Group applies a wide range of stress testing, both on individual portfolios and on the Group's consolidated positions. Stress testing program of the trading book includes sensitivity testing on changes in risk factors with various degrees of severity, as well as scenario analysis on historical events including the 1987 Equity Market Crash, 1994 Bond Market Crash, the 1997 Asian Crisis and the 11 September Event in 2001. The Group also reassessed the stress testing programme to ensure its rigour and robustness in view of the financial crisis in 2008. The Group's stress-testing regime provides senior management with an assessment of the financial impact of identified extreme events on the market risk exposures of the Group.

For BOCHK, market risk arising from the banking book is managed within various risk limits such as P/L Management Alert Limit (P/L MAL) and P/L Management Alert Trigger (P/L MAT), and the AFS economic value at risk sub-limit for the available-for-sale debt securities portfolio to control the price risk impact on our CAR. The mark-to-market result is reported to ALCO on a monthly basis.

4. Financial risk management (continued)

4.2 Market Risk (continued)

Currency risk

The tables below summarise the Group's exposure to foreign currency exchange rate risk as at 31 December. Included in the tables are the Group's assets and liabilities at carrying amounts in HK$ equivalent, categorised by the original currency.

	2008							
	Renminbi HK$'m	US Dollars HK$'m	HK Dollars HK$'m	EURO HK$'m	Japanese Yen HK$'m	Pound Sterling HK$'m	Others HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	53,381	36,592	53,720	2,662	1,425	3,163	2,326	153,269
Placements with banks and other financial institutions maturing between one and twelve months	504	31,441	38,728	5,924	–	6,487	6,634	89,718
Financial assets at fair value through profit or loss	1,274	7,670	34,817	–	–	–	51	43,812
Derivative financial instruments	–	485	19,032	99	1	–	11	19,628
Hong Kong SAR Government certificates of indebtedness	–	–	34,200	–	–	–	–	34,200
Advances and other accounts	15,056	97,002	347,249	2,915	1,622	1,002	4,647	469,493
Investment in securities								
– Available-for-sale securities	828	71,883	25,396	21,160	40,652	1,651	11,051	172,621
– Held-to-maturity securities	2,165	52,352	33,652	6,132	1,823	791	9,550	106,465
– Loans and receivables	–	2,243	9,039	108	–	110	1,095	12,595
Interests in associates	–	–	88	–	–	–	–	88
Investment properties	63	–	7,664	–	–	–	–	7,727
Properties, plant and equipment	98	–	22,697	–	–	–	–	22,795
Other assets (including deferred tax assets)	121	244	13,545	596	220	19	88	14,833
Total assets	73,490	299,912	639,827	39,596	45,743	13,223	35,453	1,147,244
Liabilities								
Hong Kong SAR currency notes in circulation	–	–	34,200	–	–	–	–	34,200
Deposits and balances of banks and other financial institutions	38,131	24,191	18,558	2,251	693	2,494	2,461	88,779
Financial liabilities at fair value through profit or loss	–	1,852	19,890	–	–	–	196	21,938
Derivative financial instruments	–	513	19,622	297	1	–	17	20,450
Deposits from customers	30,518	193,952	502,199	15,584	2,135	13,445	44,744	802,577
Debt securities in issue at amortised cost	–	148	845	–	–	–	49	1,042
Other accounts and provisions (including current and deferred tax liabilities)	1,331	9,682	17,874	325	7,907	348	646	38,113
Insurance contract liabilities	–	4,447	23,827	–	–	–	–	28,274
Subordinated liabilities	–	19,394	735	7,210	–	–	–	27,339
Total liabilities	69,980	254,179	637,750	25,667	10,736	16,287	48,113	1,062,712
Net on-balance sheet position	3,510	45,733	2,077	13,929	35,007	(3,064)	(12,660)	84,532
Off-balance sheet net notional position*	(4)	(33,929)	68,465	(13,826)	(34,817)	3,043	12,542	1,474
Contingent liabilities and commitments	9,132	62,401	176,092	3,032	551	303	1,878	253,389

* Off-balance sheet net notional position represents the net notional amounts of foreign currency derivative financial instruments, which are principally used to reduce the Group's exposure to currency movements.

4. Financial risk management (continued)

4.2 Market Risk (continued)

Currency risk (continued)

	2007							
	Renminbi HK$'m	US Dollars HK$'m	HK Dollars HK$'m	EURO HK$'m	Japanese Yen HK$'m	Pound Sterling HK$'m	Others HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	30,849	49,833	71,731	1,147	160	1,815	3,530	159,065
Placements with banks and other financial institutions maturing between one and twelve months	375	23,854	28,750	–	–	–	175	53,154
Financial assets at fair value through profit or loss	917	8,997	24,286	–	–	–	240	34,440
Derivative financial instruments	–	773	13,703	–	–	–	1	14,477
Hong Kong SAR Government certificates of indebtedness	–	–	32,770	–	–	–	–	32,770
Advances and other accounts	13,335	71,309	323,495	4,202	1,667	1,006	5,220	420,234
Investment in securities								
– Available-for-sale securities	90	62,612	26,697	7,005	28	1,321	6,900	104,653
– Held-to-maturity securities	864	84,686	59,565	2,486	–	1,554	16,273	165,428
– Loans and receivables	–	3,594	26,511	428	–	–	569	31,102
Interests in associates	–	–	83	–	–	–	–	83
Investment properties	–	–	8,058	–	–	–	–	8,058
Properties, plant and equipment	72	1	23,220	–	–	–	–	23,293
Other assets (including deferred tax assets)	69	947	19,361	161	61	145	136	20,880
Total assets	46,571	306,606	658,230	15,429	1,916	5,841	33,044	1,067,637
Liabilities								
Hong Kong SAR currency notes in circulation	–	–	32,770	–	–	–	–	32,770
Deposits and balances of banks and other financial institutions	27,173	19,422	9,090	147	2,141	92	2,534	60,599
Financial liabilities at fair value through profit or loss	–	2,717	8,688	–	–	–	–	11,405
Derivative financial instruments	–	1,257	9,824	–	–	–	11	11,092
Deposits from customers	17,360	166,416	548,223	8,432	2,492	12,284	38,399	793,606
Debt securities in issue at amortised cost	–	667	1,422	–	–	–	–	2,089
Other accounts and provisions (including current and deferred tax liabilities)	574	9,751	26,706	311	31	387	761	38,521
Insurance contract liabilities	–	4,284	18,213	–	–	–	–	22,497
Total liabilities	45,107	204,514	654,936	8,890	4,664	12,763	41,705	972,579
Net on-balance sheet position	1,464	102,092	3,294	6,539	(2,748)	(6,922)	(8,661)	95,058
Off-balance sheet net notional position	394	(97,215)	89,481	(6,478)	2,436	7,050	8,975	4,643
Contingent liabilities and commitments	4,873	55,183	163,697	4,693	1,017	259	1,581	231,303

4. Financial risk management (continued)

4.2 Market Risk (continued)

Interest rate risk

BOCHK has formulated an "Interest Rate Risk Management Policy" which sets out the framework and the methodologies to identify, measure, monitor and control interest rate risk.

Both the members of the Asset and Liability Management Committee ("ALCO") and Risk Committee ("RC") are responsible for interest rate risk management. ALCO maintains oversight of interest rate risk and RC sanctions the interest rate risk management policies formulated by ALCO. The interest rate risk is identified and measured on a daily basis. The Treasury Department manages the interest rate risk according to the established policies. The Finance Department closely monitors the related risks according to approved limits and reports the results to ALCO regularly. The Risk Management Department reviews the policies, guidelines and limits proposed by Treasury Department.

The Group's interest rate risk exposures are mainly structural. The major types of interest rate risk from structural positions are:

– repricing risk – mismatches in the maturity or repricing periods of assets and liabilities

– yield curve risk – non-parallel shifts in the yield curve, e.g. steepening or flattening yield curves, causing adverse effects on net interest income or economic value

– basis risk – different pricing basis for different transactions so that yield on assets and cost of liabilities may change by different amounts within the same repricing period

– option risk – exercise of the options embedded in assets, liabilities and off-balance sheet items inducing a change in the cashflows of assets and liabilities

Gap analysis is one of the tools used to measure the Group's exposure to repricing risk and yield curve risk. As the risk is complicated by having optionality embedded in certain products, the behavioural assumptions are made to reflect more accurately the interest rate risk exposures. The key assumption in gap analysis includes the replacement of contractual maturity of fixed rate mortgage-backed (US prime and Alt-A) securities by behavioural maturity. This gap analysis provides the Group with a static view of the maturity and repricing characteristics of its interest rate sensitive balance sheet positions.

Based on repricing gap, sensitivities of earnings and economic value to interest rate changes (Earnings at Risk and Economic Value at Risk) are assessed through a hypothetical interest rate shock of 200 basis points across the yield curve assuming parallel shifts on both sides. Limits on Earnings at Risk and Economic Value at Risk, which are the risk appetites sanctioned by RC, are controlled respectively within an approved percentage of the projected net interest income for the year and the latest capital base. The results are reported to ALCO and RC on a monthly basis respectively.

4. Financial risk management (continued)

4.2 Market Risk (continued)

Interest rate risk (continued)

Yield curve risk is also assessed by the impacts on earnings and economic value arising from steepening or flattening of the yield curve.

The impact of basis risk is gauged by the projected change in net interest income under scenarios of imperfect correlation in the adjustment of the rates earned and paid on different instruments. Ratios of assets to liabilities with similar pricing basis are established to monitor such risk.

In addition, the impact of optionality on non-maturity liabilities and prepayment of mortgage loans are evaluated under different stress scenarios.

The interest rate risk exposures in BOCHK are controlled through the use of limits:

1. Earnings at Risk limit

2. Economic Value at Risk limit

3. Interest Rate Mismatch Gap limits

In addition to adopting limits for interest rate risk control, the Group hedges its interest rate exposures by interest rate derivatives, of which plain vanilla interest rate swaps are used in most cases.

Before launching a new product or business, relevant departments are required to go through a risk assessment process, which include assessment of underlying interest rate risk and consideration of the adequacy of current risk management mechanism. Any material impact on interest rate risk noted during the risk assessment process will be reported to the Chief Financial Officer.

4. Financial risk management (continued)

4.2 Market Risk (continued)

Interest rate risk (continued)

The tables below summarise the Group's exposure to interest rate risk as at 31 December. Included in the tables are the Group's assets and liabilities at carrying amounts, categorised by the earlier of contractual repricing or maturity dates.

	2008						
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Non-interest bearing HK$'m	Total HK$'m
Assets							
Cash and balances with banks and other financial institutions	134,723	–	–	–	–	18,546	153,269
Placements with banks and other financial institutions maturing between one and twelve months	–	38,622	51,096	–	–	–	89,718
Financial assets at fair value through profit or loss	5,103	7,473	2,311	9,415	17,136	2,374	43,812
Derivative financial instruments	–	–	–	–	–	19,628	19,628
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	34,200	34,200
Advances and other accounts	366,619	76,378	20,873	1,258	159	4,206	469,493
Investment in securities							
– Available-for-sale securities	31,282	28,066	42,437	47,155	21,995	1,686	172,621
– Held-to-maturity securities	24,837	38,406	12,514	17,371	13,337	–	106,465
– Loans and receivables	1,755	2,675	8,165	–	–	–	12,595
Interests in associates	–	–	–	–	–	88	88
Investment properties	–	–	–	–	–	7,727	7,727
Properties, plant and equipment	–	–	–	–	–	22,795	22,795
Other assets (including deferred tax assets)	–	–	–	–	–	14,833	14,833
Total assets	564,319	191,620	137,396	75,199	52,627	126,083	1,147,244
Liabilities							
Hong Kong SAR currency notes in circulation	–	–	–	–	–	34,200	34,200
Deposits and balances of banks and other financial institutions	55,274	10,655	3,272	–	–	19,578	88,779
Financial liabilities at fair value through profit or loss	6,769	13,412	1,749	8	–	–	21,938
Derivative financial instruments	–	–	–	–	–	20,450	20,450
Deposits from customers	629,855	102,169	32,532	253	–	37,768	802,577
Debt securities in issue at amortised cost	459	148	435	–	–	–	1,042
Other accounts and provisions (including current and deferred tax liabilities)	8,036	116	493	136	–	29,332	38,113
Insurance contract liabilities	–	–	–	–	–	28,274	28,274
Subordinated liabilities	–	735	26,604	–	–	–	27,339
Total liabilities	700,393	127,235	65,085	397	–	169,602	1,062,712
Interest sensitivity gap	(136,074)	64,385	72,311	74,802	52,627	(43,519)	84,532

4. Financial risk management (continued)

4.2 Market Risk (continued)

Interest rate risk (continued)

	2007						
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Non-interest bearing HK$'m	Total HK$'m
Assets							
Cash and balances with banks and other financial institutions	152,746	–	–	–	–	6,319	159,065
Placements with banks and other financial institutions maturing between one and twelve months	–	42,230	10,924	–	–	–	53,154
Financial assets at fair value through profit or loss	3,562	1,839	2,164	5,894	17,397	3,584	34,440
Derivative financial instruments	–	–	–	–	–	14,477	14,477
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	32,770	32,770
Advances and other accounts	328,750	58,396	19,372	9,487	643	3,586	420,234
Investment in securities							
– Available-for-sale securities	11,668	21,320	6,257	19,959	40,869	4,580	104,653
– Held-to-maturity securities	25,562	43,920	18,534	43,022	34,390	–	165,428
– Loans and receivables	7,459	11,444	12,199	–	–	–	31,102
Interests in associates	–	–	–	–	–	83	83
Investment properties	–	–	–	–	–	8,058	8,058
Properties, plant and equipment	–	–	–	–	–	23,293	23,293
Other assets (including deferred tax assets)	–	–	–	–	–	20,880	20,880
Total assets	529,747	179,149	69,450	78,362	93,299	117,630	1,067,637
Liabilities							
Hong Kong SAR currency notes in circulation	–	–	–	–	–	32,770	32,770
Deposits and balances of banks and other financial institutions	45,728	3,428	6,897	–	–	4,546	60,599
Financial liabilities at fair value through profit or loss	6,600	2,355	1,531	919	–	–	11,405
Derivative financial instruments	–	–	–	–	–	11,092	11,092
Deposits from customers	623,009	98,440	35,157	547	–	36,453	793,606
Debt securities in issue at amortised cost	–	–	1,977	112	–	–	2,089
Other accounts and provisions (including current and deferred tax liabilities)	7,624	107	–	128	–	30,662	38,521
Insurance contract liabilities	–	–	–	–	–	22,497	22,497
Total liabilities	682,961	104,330	45,562	1,706	–	138,020	972,579
Interest sensitivity gap	(153,214)	74,819	23,888	76,656	93,299	(20,390)	95,058

4. Financial risk management (continued)

4.2 Market Risk (continued)

Interest rate risk (continued)

Sensitivity analysis to market risk exposure of banking book of the Group

The Group is principally exposed to HKD and USD in terms of interest rate risk. At 31 December 2008, if HKD and USD market interest rates had been 100 basis point higher with other variables held constant, profit after tax for the year would have been reduced by HK$89 million (2007: HK$102 million). The negative impact is reduced compared with 2007 because the short term negative interest sensitivity gaps are narrowed. Reserves would have been reduced by HK$1,390 million (2007: HK$1,598 million) of the expected reduction in valuation of available-for-sale portfolio due to the above simulated market rates movement. The sensitivity analysis set out above is illustrative only.

Interest rate exposures in banking book

The following is a summary of possible effects of market interest rates shocks on the Group's interest rate exposure for major currencies in its banking book:

	Impact on positions at 31 December	
Earnings perspective Scenarios	**2008 HK$'m**	2007 HK$'m
Down 100 basis points parallel shift in HK dollar yield curves	**(257)**	(402)
Up 100 basis points parallel shift in US dollar yield curves	**(364)**	(562)

Note:

BOC Life and BOC-CC are excluded from the analysis in 2007.

BOC Life and BOC-CC are included in the analysis in 2008.

The projections illustrate that stressful changes in market interest rates in response to exceptional but plausible events would have adverse effects both on earnings over the next twelve months and economic value. While the possible effect of interest rates shock on earnings is assessed by changes in net interest income, the possible impact on economic value is measured in terms of expected net future cash flow discounted by projected market rates. To construct stressful scenarios, severe assumptions are made, including a change in the correlation between HK dollar and US dollar interest rates, on the two separate perspectives of earnings and economic value. Other assumptions are also made on the projections, such as a parallel movement of interest rates for the banking book positions of all repricing or maturity dates. In the absence of actions that would be taken to mitigate the impact of interest rates shock, all positions are assumed to run to maturity and reprice or mature simultaneously within a given time band. The stress tests set out above are illustrative only.

4. Financial risk management (continued)

4.3 Liquidity Risk

Liquidity risk is the risk that the Group may not be able to fund increases in assets or meet obligations as they fall due without incurring unacceptable losses.

Liquidity risk management framework

The liquidity risk management framework of the Group comprises three levels. The Board of Directors and the Risk Committee are the ultimate decision making authority and are responsible for the compliance with regulatory requirements. Formulation of the risk management procedures and implementation mechanism and monitoring of the compliance are mainly the responsibilities of senior management (including Chief Executive, Chief Financial Officer, Chief Risk Officer and the Asset and Liability Management Committee). Daily management of liquidity is carried out by the treasury functions, which is assisted by other functional departments, including the finance and risk management departments which monitor the liquidity risk and provide regular reports to the management and local regulatory bodies.

The liquidity management process is adopted at the Group level. The principal subsidiaries of the Group execute their risk management strategies independently, subject to risk policies that are consistent with those of the Group, and report to the Group's management on a regular basis.

The Group funds its operations principally by accepting deposits from retail and corporate depositors. In addition, the Group may issue certificates of deposit to secure long-term funds. Funding may also be secured through adjusting the asset mix in the Group's investment portfolio. The Group uses the majority of funds raised to extend loans, to purchase debt securities or to conduct inter-bank placements.

The Group has developed a robust liquidity risk management mechanism which aims at enabling the Group to meet, even under adverse market conditions, all its maturing repayment obligations on time, and to fund all its asset growth and strategic opportunities without forced liquidation of its assets at short notice. The objective is achieved through maintenance of a highly-liquefiable assets portfolio and establishment of a diversified portfolio of liabilities.

Risk management process includes:

- Perform cash-flow projections under normal and stressed scenarios, using the net mismatch gap between assets and liabilities to estimate the prospective net funding requirements;
- Maintain a minimum mismatch ratio to control the size of the cumulative net mismatch positions;
- Maintain strong liquidity ratios to comply with both internal and external regulatory requirements;
- Ensure sound and sufficient funding sources and maintain stable and diversified core deposits;
- Maintain a proper level of highly liquid assets to serve as a liquidity buffer for emergency needs;
- Monitor the structure and stability of the deposit portfolio;
- Assess the ability to borrow from the inter-bank money market and monitor the portfolio of lenders to avoid over-reliance on the money market for funding;
- Maintain a proper contingency plan, which includes setting early warning signals (including internal indicators and market indicators) with timely monitoring procedures and establishing a management reporting system and contingency procedures.

4. Financial risk management (continued)

4.3 Liquidity Risk (continued)

Liquidity risk management framework (continued)

The Group has set up three Key Risk Indicators: 1-month liquidity ratio, 1-month mismatch ratio and loan-to-deposit ratio which are used as the major tools in the identification, measurement, monitoring and control of the liquidity risk by setting limits on, assess and monitor the ratios on a regular basis. The Group also utilises cash flow analysis, and monitors deposit stability, concentration of deposits from large depositors and liquidity profile of the investment portfolio.

Before launching a new product or business, relevant departments are required to go through a risk assessment process, which includes assessment of underlying liquidity risk and consideration of the adequacy of the current risk management mechanism. Any material impact on liquidity risk noted during the risk assessment process will be reported both to the Chief Risk Officer and the Chief Financial Officer.

(a) Analysis of undiscounted cash flows by contractual maturities

Non-derivative cash flows

The table below presents the cash flows payable by the Group as at 31 December for non-derivative financial liabilities by remaining contractual maturities.

	2008					
	Up to 1 month HK$'m	**1-3 months HK$'m**	**3-12 months HK$'m**	**1-5 years HK$'m**	**Over 5 years HK$'m**	**Total HK$'m**
Hong Kong SAR currency notes in circulation	**34,200**	**–**	**–**	**–**	**–**	**34,200**
Deposits and balances of banks and other financial institutions	**74,864**	**10,696**	**3,291**	**–**	**–**	**88,851**
Financial liabilities at fair value through profit or loss	**6,114**	**6,404**	**9,077**	**253**	**294**	**22,142**
Deposits from customers	**667,726**	**101,097**	**33,052**	**1,392**	**–**	**803,267**
Debt securities in issue at amortised cost	**459**	**148**	**436**	**–**	**–**	**1,043**
Subordinated liabilities	**–**	**7**	**1,051**	**4,978**	**32,233**	**38,269**
Other financial liabilities	**27,329**	**198**	**1,836**	**4**	**238**	**29,605**
	810,692	**118,550**	**48,743**	**6,627**	**32,765**	**1,017,377**

	2007					
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Total HK$'m
Hong Kong SAR currency notes in circulation	32,770	–	–	–	–	32,770
Deposits and balances of banks and other financial institutions	50,290	3,456	6,951	–	–	60,697
Financial liabilities at fair value through profit or loss	2,563	1,966	4,788	1,976	364	11,657
Deposits from customers	659,884	99,025	35,789	585	–	795,283
Debt securities in issue at amortised cost	7	13	2,021	116	–	2,157
Other financial liabilities	29,192	412	450	133	501	30,688
	774,706	104,872	49,999	2,810	865	933,252

4. Financial risk management (continued)

4.3 Liquidity Risk (continued)

(a) Analysis of undiscounted cash flows by contractual maturities (continued)

Derivative cash flows

(i) Derivatives settled on a net basis

The Group's derivatives that will be settled on a net basis include:

– Foreign exchange derivatives: non-deliverable OTC currency options, currency futures, non-deliverable currency forwards;

– Interest rate derivatives: interest rate swaps;

– Equity derivatives: exchange traded equity options; and

– Bullion derivatives: bullion margin contracts.

The table below analyses the Group's derivative financial liabilities as at 31 December that will be settled on a net basis into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash flows of derivatives with net negative fair value.

	2008					
	Up to 1 month HK$'m	**1-3 months HK$'m**	**3-12 months HK$'m**	**1-5 years HK$'m**	**Over 5 years HK$'m**	**Total HK$'m**
Derivatives settled on a net basis						
– Foreign exchange derivatives	**(10,465)**	**(99)**	**(235)**	**–**	**–**	**(10,799)**
– Interest rate derivatives	**–**	**(178)**	**(884)**	**(3,023)**	**(724)**	**(4,809)**
– Bullion derivatives	**(91)**	**–**	**–**	**–**	**–**	**(91)**
	(10,556)	**(277)**	**(1,119)**	**(3,023)**	**(724)**	**(15,699)**

	2007					
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Total HK$'m
Derivatives settled on a net basis						
– Foreign exchange derivatives	(7,221)	(12)	456	21	–	(6,756)
– Interest rate derivatives	(1)	(23)	(143)	(309)	(66)	(542)
– Equity derivatives	–	(58)	–	–	–	(58)
– Bullion derivatives	(1,110)	–	–	–	–	(1,110)
	(8,332)	(93)	313	(288)	(66)	(8,466)

4. Financial risk management (continued)

4.3 Liquidity Risk (continued)

(a) Analysis of undiscounted cash flows by contractual maturities (continued)

Derivative cash flows (continued)

(ii) Derivatives settled on a gross basis

The Group's derivatives that will be settled on a gross basis include OTC currency options, currency forwards and cross currency interest rate swaps, OTC equity options, equity linked swaps and bullion swaps.

The table below analyses the Group's derivative financial instruments as at 31 December that will be settled on a gross basis into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. The amounts disclosed in the table are the gross contractual undiscounted cash flows for all derivatives that are settled on a gross basis.

	2008				
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Total HK$'m
Derivatives settled on a gross basis					
– Foreign exchange derivatives:					
– Outflow	(146,872)	(69,270)	(62,608)	(1,722)	(280,472)
– Inflow	145,552	68,892	62,246	1,709	278,399
– Interest rate derivatives:					
– Outflow	–	–	–	–	–
– Inflow	316	–	–	–	316
– Equity derivatives:					
– Outflow	(444)	(236)	(1,659)	–	(2,339)
– Inflow	462	237	1,659	–	2,358
– Bullion derivatives:					
– Outflow	(226)	(131)	–	–	(357)
– Inflow	–	–	–	–	–
Total outflow	(147,542)	(69,637)	(64,267)	(1,722)	(283,168)
Total inflow	146,330	69,129	63,905	1,709	281,073

4. Financial risk management (continued)

4.3 Liquidity Risk (continued)

(a) Analysis of undiscounted cash flows by contractual maturities (continued)

Derivative cash flows (continued)

(ii) Derivatives settled on a gross basis (continued)

	2007				
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Total HK$'m
Derivatives settled on a gross basis					
– Foreign exchange derivatives:					
– Outflow	(96,928)	(52,508)	(24,477)	(1,869)	(175,782)
– Inflow	96,743	52,301	24,380	1,866	175,290
– Interest rate derivatives:					
– Outflow	–	–	–	–	–
– Inflow	–	316	–	–	316
– Equity derivatives:					
– Outflow	(128)	(70)	(1,002)	(28)	(1,228)
– Inflow	221	99	1,002	28	1,350
– Bullion derivatives:					
– Outflow	(223)	(427)	(715)	–	(1,365)
– Inflow	–	–	–	–	–
Total outflow	(97,279)	(53,005)	(26,194)	(1,897)	(178,375)
Total inflow	96,964	52,716	25,382	1,894	176,956

Off-balance sheet items

Loan commitments

The contractual amounts of the Group's off-balance sheet financial instruments as at 31 December 2008 that commit to extend credit to customers and other facilities amounting to HK$219,336 million (2007: HK$193,027 million) are maturing no later than 1 year.

Financial guarantees and other financial facilities

Financial guarantees as at 31 December 2008 amounting to HK$34,053 million (2007: HK$38,276 million) are maturing no later than 1 year.

4. Financial risk management (continued)

4.3 Liquidity Risk (continued)

(b) Maturity analysis

Tables below analyse assets and liabilities of the Group as at 31 December into relevant maturity groupings based on the remaining period at balance sheet date to the contractual maturity date.

	2008							
	On demand HK$'m	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Indefinite HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	77,935	75,334	–	–	–	–	–	153,269
Placements with banks and other financial institutions maturing between one and twelve months	–	–	38,622	51,096	–	–	–	89,718
Financial assets at fair value through profit or loss								
– debt securities held for trading								
– certificates of deposit held	–	–	–	–	–	–	–	–
– others	–	4,628	6,685	1,927	685	6	–	13,931
– debt securities designated at fair value through profit or loss								
– certificates of deposit held	–	25	–	–	2,008	1,536	–	3,569
– others	–	226	426	384	7,058	15,840	4	23,938
– equity securities	–	–	–	–	–	–	2,374	2,374
Derivative financial instruments	14,844	756	1,253	1,439	1,216	120	–	19,628
Hong Kong SAR Government certificates of indebtedness	34,200	–	–	–	–	–	–	34,200
Advances and other accounts								
– advances to customers	21,980	17,656	31,084	51,336	197,399	137,684	1,007	458,146
– trade bills	–	2,910	4,022	677	–	–	–	7,609
– advances to banks and other financial institutions	27	–	–	885	2,826	–	–	3,738
Investment in securities								
– debt securities held for available-for-sale								
– certificates of deposit held	–	–	23	5,236	2,096	–	–	7,355
– others	–	19,849	13,349	40,054	58,135	26,164	6,029	163,580
– debt securities held for held-to-maturity								
– certificates of deposit held	–	2,040	2,173	2,162	6,073	–	–	12,448
– others	–	2,115	4,933	14,560	49,480	15,905	7,024	94,017
– debt securities held for loans and receivables	–	1,755	2,675	8,165	–	–	–	12,595
– equity securities	–	–	–	–	–	–	1,686	1,686
Interests in associates	–	–	–	–	–	–	88	88
Investment properties	–	–	–	–	–	–	7,727	7,727
Properties, plant and equipment	–	–	–	–	–	–	22,795	22,795
Other assets (including deferred tax assets)	2,185	12,027	11	126	157	–	327	14,833
Total assets	151,171	139,321	105,256	178,047	327,133	197,255	49,061	1,147,244
Liabilities								
Hong Kong SAR currency notes in circulation	34,200	–	–	–	–	–	–	34,200
Deposits and balances of banks and other financial institutions	61,206	13,646	10,655	3,272	–	–	–	88,779
Financial liabilities at fair value through profit or loss								
– certificates of deposit issued	–	–	–	858	–	–	–	858
– others	–	6,111	6,363	8,170	166	270	–	21,080
Derivative financial instruments	10,556	2,137	1,689	1,967	2,822	1,279	–	20,450
Deposits from customers	428,849	238,769	100,891	32,696	1,372	–	–	802,577
Debt securities in issue at amortised cost	–	459	148	435	–	–	–	1,042
Other accounts and provisions (including current and deferred tax liabilities)	16,328	16,003	204	2,341	2,857	232	148	38,113
Insurance contract liabilities	1,406	792	2	16	18,033	8,025	–	28,274
Subordinated liabilities	–	–	–	21	735	26,583	–	27,339
Total liabilities	552,545	277,917	119,952	49,776	25,985	36,389	148	1,062,712
Net liquidity gap	(401,374)	(138,596)	(14,696)	128,271	301,148	160,866	48,913	84,532

4. Financial risk management (continued)

4.3 Liquidity Risk (continued)

(b) Maturity analysis (continued)

	2007							
	On demand HK$'m	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Indefinite HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	40,100	118,965	–	–	–	–	–	159,065
Placements with banks and other financial institutions maturing between one and twelve months	–	–	42,230	10,924	–	–	–	53,154
Financial assets at fair value through profit or loss								
– debt securities held for trading								
– certificates of deposit held	–	–	–	80	–	–	–	80
– others	–	1,697	779	2,342	1,307	32	–	6,157
– debt securities designated at fair value through profit or loss								
– certificates of deposit held	–	–	–	415	393	2,316	–	3,124
– others	–	36	343	272	5,376	15,468	–	21,495
– equity securities	–	–	–	–	–	–	3,584	3,584
Derivative financial instruments	12,686	228	129	929	459	46	–	14,477
Hong Kong SAR Government certificates of indebtedness	32,770	–	–	–	–	–	–	32,770
Advances and other accounts								
– advances to customers	21,196	16,345	25,968	43,608	173,120	130,067	1,373	411,677
– trade bills	12	2,815	2,227	280	–	–	–	5,334
– advances to banks and other financial institutions	27	–	600	440	2,156	–	–	3,223
Investment in securities								
– debt securities held for available-for-sale								
– certificates of deposit held	–	701	462	2,614	3,689	–	–	7,466
– others	–	5,886	3,776	7,515	30,790	44,084	556	92,607
– debt securities held for held-to-maturity								
– certificates of deposit held	–	1,097	1,490	2,426	6,351	624	–	11,988
– others	–	4,278	12,309	17,166	81,918	34,031	3,738	153,440
– debt securities held for loans and receivables	–	7,459	11,444	12,199	–	–	–	31,102
– equity securities	–	–	–	–	–	–	4,580	4,580
Interests in associates	–	–	–	–	–	–	83	83
Investment properties	–	–	–	–	–	–	8,058	8,058
Properties, plant and equipment	–	–	–	–	–	–	23,293	23,293
Other assets (including deferred tax assets)	3,360	16,219	24	174	202	–	901	20,880
Total assets	110,151	175,726	101,781	101,384	305,761	226,668	46,166	1,067,637
Liabilities								
Hong Kong SAR currency notes in circulation	32,770	–	–	–	–	–	–	32,770
Deposits and balances of banks and other financial institutions	28,200	22,074	3,428	6,897	–	–	–	60,599
Financial liabilities at fair value through profit or loss								
– certificates of deposit issued	–	–	–	1,086	868	–	–	1,954
– others	–	2,554	1,925	3,680	983	309	–	9,451
Derivative financial instruments	8,320	418	355	954	831	214	–	11,092
Deposits from customers	329,544	329,918	98,440	35,157	547	–	–	793,606
Debt securities in issue at amortised cost	–	–	–	1,977	112	–	–	2,089
Other accounts and provisions (including current and deferred tax liabilities)	15,446	15,543	1,071	1,660	4,100	–	701	38,521
Insurance contract liabilities	2,054	–	–	535	13,786	6,122	–	22,497
Total liabilities	416,334	370,507	105,219	51,946	21,227	6,645	701	972,579
Net liquidity gap	(306,183)	(194,781)	(3,438)	49,438	284,534	220,023	45,465	95,058

4. Financial risk management (continued)

4.3 Liquidity Risk (continued)

(b) Maturity analysis (continued)

The above maturity classifications have been prepared in accordance with relevant provisions under the Banking (Disclosure) Rules. The Group has reported assets such as advances and debt securities which have been overdue for not more than one month as "Repayable on demand". In the case of an asset that is repayable by different payments or instalments, only that portion of the asset that is actually overdue is reported as overdue. Any part of the asset that is not due is reported according to the residual maturity unless the repayment of the asset is in doubt in which case the amount is reported as "Indefinite". The above assets are stated after deduction of provisions, if any.

The analysis of debt securities by remaining period to maturity is disclosed in order to comply with relevant provisions under the Banking (Disclosure) Rules. The disclosure does not imply that the securities will be held to maturity.

The above analysis in respect of insurance contract liabilities represents the estimated timing of net cash outflows resulting from recognised insurance contract liabilities on the balance sheet as at 31 December.

4.4 Insurance Risk

The Group is in the business of insuring against the risk of mortality, morbidity, disability, critical illness, accidents and related risks. The Group manages these risks through the application of its underwriting policies and reinsurance arrangement.

The underwriting strategy is intended to set premium pricing at an appropriate level that corresponds with the underlying exposure of the risks underwritten. Screening processes, such as the review of health condition and family medical history, are also included in the Group's underwriting procedures.

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

For the in-force insurance contracts, most of the underlying insurance liabilities are related to endowment and unit-linked insurance products.

Uncertainty in the estimation of future benefit payments and premium receipts for long-term insurance contracts arises from the unpredictability of long-term changes in overall levels of mortality and persistency. In order to assess the uncertainty due to the mortality assumption and lapse assumption, the Group conducts mortality study and lapse study in order to determine the appropriate assumptions. In these studies, consistent results are reflected in both assumptions with appropriate margins.

4. Financial risk management (continued)

4.5 Capital Management

The major objective of the Group's capital management is to maximise total shareholders' return while maintaining a capital adequacy position in relation to the Group's overall risk profile. The Group periodically reviews its capital structure and adjusts the capital mix where appropriate to achieve the required rate of return on capital.

The Group has developed and maintained a sound framework of policies and controls on capital management to support the development of the Group's business and to meet the statutory capital adequacy ratio. ALCO monitors the Group's capital adequacy. The Group has complied with all the statutory capital standards for all the periods.

For the implementation of Basel II in 2007, the Group has adopted the standardised approach under Pillar one to calculate the capital charge on credit risk, market risk and operational risk in compliance with the Banking (Capital) Rules. This new regulatory capital framework aligns regulatory capital requirements more closely with the inherent risks.

In 2007, the Group established an Internal Capital Adequacy Assessment Process (ICAAP). Through this process, each material risk from the Group's main activities is assessed by pre-defined assessment models, and a comprehensive judgment of the overall risk profile is decided subsequently by taking into account the Group's governance culture. Finally, the minimum CAR is derived through the procedures to relate the Group's overall risk profile to its capital adequacy. The minimum CAR aims to cover the various material risks undertaken by the Group. The Group considers this ICAAP process as an on-going process for capital management and periodically reviews its capital structure and adjusts it in relation to the overall risk profile.

In addition, the annual capital plans of the Group are drawn up and discussed by the ALCO and submitted to the board for approval. The plan is built up by assessing the impacts by various factors upon CAR such as the business strategies, return on equity, risk appetite, credit rating, as well as regulatory requirements, and based on this study to derive our future capital demand and the way to obtain the capital sources. The plan is to ensure the Group's capital adequacy and achieve optimal capital structure in order to align with its business development needs and risk profile.

(a) Capital adequacy ratio

	2008	2007
Capital adequacy ratio	**16.17%**	13.08%
Core capital ratio	**10.86%**	12.23%

The capital ratios are computed on the consolidated basis that comprises the positions of BOCHK and certain subsidiaries specified by the HKMA for its regulatory purposes and in accordance with the Banking (Capital) Rules.

The differences between the basis of consolidation for accounting and regulatory purposes are described in "Appendix – Subsidiaries of the Company" on page 227.

4. Financial risk management (continued)

4.5 Capital Management (continued)

(b) Components of capital base after deductions

The consolidated capital base after deductions used in the calculation of the above capital adequacy ratio as at 31 December and reported to the HKMA is analysed as follows:

	2008 HK$'m	2007 HK$'m
Core capital:		
Paid up ordinary share capital	**43,043**	43,043
Reserves	**18,049**	22,611
Profit and loss account	**2,956**	207
Minority interests	**1,124**	1,284
	65,172	67,145
Deductions from core capital	**(1,536)**	(483)
Core capital	**63,636**	66,662
Supplementary capital:		
Fair value gains arising from holdings of available-for-sale securities	**87**	18
Fair value gains arising from holdings of securities designated at fair value through profit or loss	**–**	9
Collective loan impairment allowances	**1,502**	1,004
Regulatory reserve	**4,503**	4,130
Term subordinated debt	**26,583**	–
	32,675	5,161
Deductions from supplementary capital	**(1,536)**	(483)
Supplementary capital	**31,139**	4,678
Total capital base after deductions	**94,775**	71,340

Subsidiaries which are not included in the consolidation group for the calculation of capital adequacy ratios are denoted in "Appendix – Subsidiaries of the Company" on page 227. Investment costs in such subsidiaries are deducted from the capital base.

Term subordinated debt represents subordinated loans qualified as Tier 2 Capital of BOCHK pursuant to the regulatory requirements of the HKMA. Going forward, BOCHK will continue to take proactive measures to manage its capital, with a view to meet its strategic development needs.

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks

The capital adequacy ratios shown above are calculated on the consolidation basis for regulatory purposes in accordance with the Banking (Capital) Rules. The table below summaries the capital requirements and capital charge calculated by applying 8% on the risk-weighted amounts, computed on the same consolidation basis for credit, market, and operational risks.

	2008 HK$'m	2007 HK$'m
Credit risk	**43,609**	40,878
Market risk	**728**	640
Operational risk	**3,531**	3,131
	47,868	44,649

(i) Capital requirements for credit risk

	2008					
	Total exposures HK$'m	Exposures after CRM* Rated HK$'m	Exposures after CRM* Unrated HK$'m	Risk-weighted amount Rated HK$'m	Risk-weighted amount Unrated HK$'m	Capital requirement** HK$'m
On-balance sheet exposures						
Sovereign	137,693	142,513	–	602	–	48
Public sector entity	5,289	21,507	–	4,301	–	344
Multilateral development bank	5,887	5,887	–	–	–	–
Bank	321,992	318,872	12,807	96,789	5,909	8,216
Securities firm	12	–	–	–	–	–
Corporate	321,192	67,091	234,426	34,821	234,426	21,540
Cash items	39,451	–	39,451	–	–	–
Regulatory retail	31,919	–	30,312	–	22,734	1,819
Residential mortgage loans	149,084	–	132,716	–	53,708	4,296
Other exposures which are not past due	34,896	–	34,313	–	34,313	2,745
Past due exposures	800	–	800	–	871	70
Total for on-balance sheet exposures	1,048,215	555,870	484,825	136,513	351,961	39,078
Off-balance sheet exposures						
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	46,045	11,156	34,889	6,144	34,113	3,221
OTC derivative transactions	6,243	5,750	493	1,871	448	186
Total for off-balance sheet exposures	52,288	16,906	35,382	8,015	34,561	3,407
Total for non-securitisation exposures	1,100,503	572,776	520,207	144,528	386,522	42,485
Securitisation exposures	24,144	24,144	–	14,057	–	1,124
	1,124,647	596,920	520,207	158,585	386,522	43,609

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks (continued)

(i) Capital requirements for credit risk (continued)

	2007					
	Total	Exposures after CRM*		Risk-weighted amount		Capital
	exposures	Rated	Unrated	Rated	Unrated	requirement**
	HK$'m	HK$'m	HK$'m	HK$'m	HK$'m	HK$'m
On-balance sheet exposures						
Sovereign	46,140	47,096	–	603	–	48
Public sector entity	6,091	22,366	–	4,473	–	358
Multilateral development bank	1,396	1,396	–	–	–	–
Bank	357,628	349,758	12,481	90,907	4,856	7,661
Securities firm	34	–	13	–	6	1
Corporate	297,638	77,134	208,248	34,861	208,248	19,449
Cash items	37,446	–	37,446	–	–	–
Regulatory retail	29,867	–	28,232	–	21,174	1,694
Residential mortgage loans	137,562	–	121,271	–	48,718	3,897
Other exposures which are not past due	37,667	–	36,892	–	36,891	2,951
Past due exposures	1,080	71	1,009	14	1,095	89
Total for on-balance sheet exposures	952,549	497,821	445,592	130,858	320,988	36,148
Off-balance sheet exposures						
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	54,841	8,046	46,795	4,864	42,494	3,789
OTC derivative transactions	3,717	2,565	1,152	643	1,101	139
Total for off-balance sheet exposures	58,558	10,611	47,947	5,507	43,595	3,928
Total for non-securitisation exposures	1,011,107	508,432	493,539	136,365	364,583	40,076
Securitisation exposures	50,110	50,110	–	10,022	–	802
	1,061,217	558,542	493,539	146,387	364,583	40,878

* Recognised credit risk mitigation satisfying the requirements and conditions set out in the Banking (Capital) Rules.

** For disclosure purposes, capital requirement is calculated by applying 8% on the risk-weighted amount, which may differ from the Group's actual regulatory capital.

As at 31 December 2008, credit exposures deducted from the capital base amounted to HK$2,571 million (2007: HK$472 million).

The Group used the STC approach for calculation of credit risk.

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks (continued)

(i) Capital requirements for credit risk (continued)

The ECAIs recognised by the Group includes Standard & Poor's, Moody's and Fitch. The Group adopted external rating based approach to determine the risk weight of the following classes of exposures, including those of securitisation exposures:

– Sovereign

– Public sector entity

– Multilateral development bank

– Bank

– Securities firm

– Corporate

The process the Group used to map ECAI issuer ratings to exposures booked in the banking book is a process prescribed in Part 4 of the Banking (Capital) Rules.

Counterparty credit risk exposures

The Group's counterparty credit risk arising from over-the-counter ("OTC") derivative transactions, repo-style transactions both in trading and banking book is subject to the same risk management framework as above mentioned. The Group established credit limit through formal credit approval procedures to control the pre-settlement credit risk arising from derivatives transactions and settlement limit to control the settlement risk arising from foreign exchange-related transactions in both the trading book and banking book. The Group monitors the risk exposure due to fluctuations in the market value by determining the current exposure value of the transactions. Exceptions or excesses are timely and closely identified and monitored by credit risk management units.

As the Group has not implemented capital allocation policy, there is no internal capital assigned for counterparty credit exposures.

The Group's policy for securing and managing collateral is applicable in managing counterparty credit risk. Besides, we established prudent eligibility criteria and haircut policy of debt securities secured as collateral for repo-style transactions.

The Group formulated policy for classification of credit assets according to the probability of default of individual counterparty and the period of overdue. If there is objective evidence that an impairment loss has been incurred, impairment allowance will be provided according to regulatory and HK accounting requirements.

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks (continued)

(i) Capital requirements for credit risk (continued)

Counterparty credit risk exposures (continued)

The following table summarises the Group's exposures to counterparty credit risk arising from OTC derivative transactions:

	2008 HK$'m	2007 HK$'m
Gross total positive fair value	**3,120**	1,239
Credit equivalent amount	**6,243**	3,717
Less: recognised collateral	**–**	–
Net credit equivalent amount	**6,243**	3,717
Net credit equivalent amount analysed by type of issuer:		
Sovereign	**4**	8
Bank	**5,830**	2,654
Corporate	**406**	1,006
Others	**3**	49
	6,243	3,717
Risk weighted amount analysed by type of issuer:		
Sovereign	**4**	8
Bank	**1,908**	685
Corporate	**405**	1,002
Others	**3**	49
	2,320	1,744
Notional amount of recognised credit derivative contracts which provide credit protection	**–**	–

There is no effect of valid bilateral netting agreement on the credit equivalent amounts of the derivative transactions as at 31 December 2008 (2007: Nil).

There are no outstanding repo-style transactions or credit derivative contracts as at 31 December 2008 and 2007.

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks (continued)

(i) Capital requirements for credit risk (continued)

Credit risk mitigation

For those collaterals recognised under capital management, the Group has well-defined policies and procedures for collateral valuation and management which is compliant with the operational requirements for recognised collateral for credit risk mitigation stated in the Banking (Capital) Rules.

The main types of recognised collaterals include cash deposit, gold bullion, debt securities, equities and funds for non past-due exposures. In addition, real property collateral is also recognised for past due exposures. Those collaterals taken by the Group are compliant with the comprehensive approach in its treatment of recognised collateral for credit risk mitigation in capital calculation as mentioned in the Banking (Capital) Rules.

According to the Banking (Capital) Rules, the recognised guarantees for credit risk mitigation under STC approach includes the guarantee given by sovereign, public sector entity, multilateral development bank, bank, securities firm with a lower risk weights than the counterparty; or corporate with external credit rating A- or above.

The concentration risk management for collaterals is embedded in the collateral management policy, including stress testing. To cope with the requirement under Pillar two, we have adopted a scorecard methodology to assess our credit concentration risk and consider whether add-on capital charge is needed to cover this risk.

Up to the date of report, the Group has not used any recognised credit derivative contracts, on- or off-balance sheet recognised netting for credit risk mitigation yet.

Exposures, other than those arising from OTC derivative transactions and repo-style transactions, covered by recognised credit risk mitigation are analysed as follows:

	2008		2007	
	Covered by recognised collateral HK$'m	**Covered by recognised guarantees HK$'m**	Covered by recognised collateral HK$'m	Covered by recognised guarantees HK$'m
On-balance sheet exposures				
Public sector entity	**–**	**70**	–	–
Securities firm	**12**	**–**	21	–
Corporate	**5,266**	**23,915**	6,593	16,950
Regulatory retail	**1,575**	**40**	1,590	45
Residential mortgage loans	**84**	**16,283**	157	16,134
Other exposures which are not past due	**583**	**–**	775	–
Past due exposures	**688**	**34**	862	74
Off-balance sheet exposures	**11,145**	**8,161**	9,069	8,612
	19,353	**48,503**	19,067	41,815

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks (continued)

(i) Capital requirements for credit risk (continued)

Asset securitisation

The Group has not acted as an originating institution in respect of securitisation transactions during the year. Securitisation exposures arising from the Group's investing activities are analysed as follows:

	2008			
	Total exposures HK$'m	**Risk weighted amounts HK$'m**	**Capital requirement HK$'m**	**Exposures deducted from capital base HK$'m**
Traditional securitisations				
Residential mortgages	**19,830**	**13,175**	**1,054**	**1,769**
Commercial mortgages	**1,382**	**277**	**22**	**–**
Student loans	**1,953**	**390**	**31**	**–**
Auto loans	**785**	**176**	**14**	**–**
Credit card receivables	**194**	**39**	**3**	**–**
	24,144	**14,057**	**1,124**	**1,769**

	2007			
	Total exposures HK$'m	Risk weighted amounts HK$'m	Capital requirement HK$'m	Exposures deducted from capital base HK$'m
Traditional securitisations				
Residential mortgages	44,370	8,874	710	–
Commercial mortgages	1,560	312	25	–
Student loans	1,641	328	26	–
Auto loans	1,760	352	28	–
Credit card receivables	779	156	13	–
	50,110	10,022	802	–

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks (continued)

(ii) Capital charge for market risk

	2008 **HK$'m**	2007 HK$'m
Interest rate exposures	**569**	450
Equity exposures	**14**	56
Foreign exchange exposures	**142**	132
Commodity exposures	**3**	2
	728	640

The Group used the STM approach for calculation of market risk.

The Group's positions covered by the STM approach are as follows:

	2008		2007	
	Long **HK$'m**	**Short** **HK$'m**	Long HK$'m	Short HK$'m
Interest rate exposures	**383,286**	**382,934**	208,062	207,180
Equity exposures	**82**	**22**	333	303
Foreign exchange exposures (Net)	**1,463**	**–**	1,458	–
Commodities exposures	**11**	**15**	11	20
	384,842	**382,971**	209,864	207,503

Equity exposures in banking book

Equity holdings in other entities are accounted for in accordance with the underlying intentions of holdings, at the outset of the acquisition of the respective equity exposures. Bookings for the equity holdings taken for relationship and strategic reasons will be separated from the bookings for equity holdings taken for other reasons (including the reason of capital appreciation).

Gains or losses related to equity exposures are summarised below:

	2008 **HK$'m**	2007 HK$'m
Realised gains from sales or liquidations	**97**	1
Unrealised gains on revaluation recognised in reserves but not through profit or loss	**163**	27
Unrealised gains included in supplementary capital	**87**	18

4. Financial risk management (continued)

4.5 Capital Management (continued)

(c) Capital charge for credit, market and operational risks (continued)

(iii) Capital charge for operational risk

	2008 **HK$'m**	2007 HK$'m
Capital charge for operational risk	**3,531**	3,131

The Group used the STO approach for calculation of operational risk.

4.6 Fair values of financial assets and liabilities

Fair value estimates are made at a specific point in time based on relevant market information and information about various financial instruments. The following methods and assumptions have been used to estimate the fair value of each class of financial instrument as far as practicable.

Balances with banks and other financial institutions and Trade bills

The maturities of these financial assets and liabilities are within one year and the carrying value approximates fair value.

Advances to customers, banks and other financial institutions

Substantially all the advances to customers, banks and other financial institutions are on floating rate terms, bear interest at prevailing market interest rates and their carrying value approximates fair value.

Held-to-maturity securities

Fair value for held-to-maturity securities is based on market prices or broker/dealer price quotations. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics. The carrying value and fair value as at 31 December 2008 amounted to HK$106,465 million (2007: HK$165,428 million) and HK$103,220 million (2007: HK$166,110 million) respectively.

Loans and receivables, Certificates of deposit issued and Debt securities in issue

A discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity and their carrying value approximates fair value.

Deposits from customers

Substantially all the deposits from customers mature within one year from balance sheet date and their carrying value approximates fair value.

Subordinated liabilities

All the subordinated liabilities are on floating rate terms, bear interest at prevailing market interest rates and their carrying value approximates fair value.

5. Net interest income

	2008 HK$'m	2007 HK$'m
Interest income		
Cash and due from banks and other financial institutions	**5,523**	8,311
Advances to customers	**16,246**	20,803
Listed investments	**3,042**	2,593
Unlisted investments	**10,067**	13,698
Others	**403**	651
	35,281	46,056
Interest expense		
Due to banks, customers and other financial institutions	**(13,968)**	(25,787)
Debt securities in issue	**(130)**	(103)
Subordinated liabilities	**(250)**	–
Others	**(776)**	(771)
	(15,124)	(26,661)
Net interest income	**20,157**	19,395

Included within interest income is HK$20 million (2007: HK$47 million) of interest with respect to income recognised on advances classified as impaired for the year ended 31 December 2008. Interest accrued on impaired investment in securities amounted to HK$362 million (2007: HK$1 million).

Included within interest income and interest expense are HK$33,664 million (2007: HK$44,791 million) and HK$14,338 million (2007: HK$25,907 million) for financial assets and financial liabilities that are not recognised at fair value through profit or loss respectively.

6. Net fees and commission income

	2008 HK$'m	2007 HK$'m
Fees and commission income		
Securities brokerage		
– Stockbroking	**2,380**	3,560
– Bonds	**259**	211
Credit cards	**1,220**	1,027
Bills commissions	**683**	588
Loan commissions	**513**	347
Payment services	**486**	464
Asset management	**218**	683
Insurance	**209**	153
Trust services	**173**	153
Guarantees	**37**	32
Others		
– RMB business	**223**	137
– currency exchange	**204**	184
– safe deposit box	**188**	182
– information search	**44**	42
– correspondent banking	**44**	37
– low deposit balance accounts	**28**	33
– postage and telegrams	**18**	27
– dormant accounts	**17**	20
– agency services	**16**	20
– BOC cards	**10**	28
– sundries	**244**	249
	7,214	8,177
Fees and commission expenses	**(2,035)**	(1,903)
Net fees and commission income	**5,179**	6,274
Of which arise from		
– financial assets or financial liabilities not at fair value through profit or loss		
– Fees and commission income	**680**	403
– Fees and commission expenses	**(42)**	(58)
	638	345
– trust and other fiduciary activities		
– Fees and commission income	**296**	254
– Fees and commission expenses	**(6)**	(6)
	290	248

7. Net trading income

	2008 HK$'m	2007 HK$'m
Net gain/(loss) from:		
– foreign exchange and foreign exchange products	**1,809**	800
– interest rate instruments	**(127)**	30
– equity instruments	**119**	181
– commodities	**113**	2
	1,914	1,013

8. Net loss on investment in securities

	2008 HK$'m	2007 HK$'m
Net loss from disposal of available-for-sale securities	**(14)**	(55)
Net gain from redemption of held-to-maturity securities	**–**	2
Net loss from disposal of loans and receivables	**(1)**	–
	(15)	(53)

9. Net insurance premium income

	2008 HK$'m	2007 HK$'m
Gross earned premiums	**5,921**	8,435
Less: Gross written premiums ceded to reinsurers	**(30)**	(9)
Net insurance premium income	**5,891**	8,426

10. Other operating income

	2008 HK$'m	2007 HK$'m
Dividend income from investment in securities		
– listed investments	**109**	–
– unlisted investments	**17**	15
Gross rental income from investment properties	**320**	254
Less: Outgoings in respect of investment properties	**(52)**	(52)
Others	**167**	554
	561	771

Included in the "Outgoings in respect of investment properties" is HK$2 million (2007: HK$3 million) of direct operating expenses related to investment properties that were not let during the year.

11. Net insurance benefits and claims

	2008 HK$'m	2007 HK$'m
Claims, benefits and surrenders paid	**1,297**	1,360
Movement in liabilities	**6,419**	8,084
Gross claims, benefits and surrenders paid and movement in liabilities	**7,716**	9,444
Less: Reinsurers' share of claims, benefits and surrenders paid and movement in liabilities	**(7)**	(4)
Net insurance claims, benefits and surrenders paid and movement in liabilities	**7,709**	9,440

12. Net charge of impairment allowances

	2008 HK$'m	2007 HK$'m
Advances to customers		
Individually assessed		
– new allowances	**813**	330
– releases	**(83)**	(299)
– recoveries	**(722)**	(1,311)
Net charge/(reversal) of individually assessed loan impairment allowances (Note 27)	**8**	(1,280)
Collectively assessed		
– new allowances	**691**	625
– releases	**(10)**	–
– recoveries	**(28)**	(30)
Net charge of collectively assessed loan impairment allowances (Note 27)	**653**	595
Net charge/(reversal) of loan impairment allowances	**661**	(685)
Available-for-sale securities		
Net charge of impairment losses on available-for-sale securities Individually assessed	**7,839**	289
Held-to-maturity securities		
Net charge of impairment allowances on held-to-maturity securities Individually assessed (Note 28)	**4,061**	1,844
Others	**12**	–
Net charge of impairment allowances	**12,573**	1,448

13. Operating expenses

	2008 HK$'m	2007 HK$'m
Staff costs (including directors' emoluments)		
– salaries and other costs	**4,128**	4,341
– termination benefit	**55**	14
– pension cost	**371**	301
	4,554	4,656
Premises and equipment expenses (excluding depreciation)		
– rental of premises	**408**	347
– information technology	**411**	378
– others	**257**	233
	1,076	958
Depreciation (Note 32)	**992**	787
Auditors' remuneration		
– audit services	**33**	32
– non-audit services	**5**	5
Other operating expenses	**2,111**	1,335
	8,771	7,773

14. Net (loss)/gain from disposal of/fair value adjustments on investment properties

	2008 HK$'m	2007 HK$'m
Net gain on disposal of investment properties	**14**	8
Net (loss)/gain on fair value adjustments on investment properties (Note 31)	**(132)**	1,056
	(118)	1,064

15. Net gain from disposal/revaluation of properties, plant and equipment

	2008 HK$'m	2007 HK$'m
Net gain on disposal of premises	**35**	23
Net loss on disposal of other fixed assets	**(4)**	(16)
Net (loss)/gain on revaluation of premises (Note 32)	**(24)**	19
	7	26

16. Taxation

Taxation in the income statement represents:

	2008 **HK$'m**	2007 HK$'m
Hong Kong profits tax		
Current tax		
– current year taxation	**1,326**	2,985
– over-provision in prior years	**(13)**	(29)
	1,313	2,956
Deferred tax (credit)/charge (Note 39)		
– origination and reversal of temporary differences	**(341)**	252
– impact of change of Hong Kong tax rate	**(123)**	–
	(464)	252
Hong Kong profits tax	**849**	3,208
Overseas taxation	**222**	101
	1,071	3,309

Hong Kong profits tax has been provided at the rate of 16.5% (2007: 17.5%) on the estimated assessable profits arising in Hong Kong during the year. Taxation on overseas profits has been calculated on the estimated assessable profits for the year at the rates of taxation prevailing in the countries in which the Group operates.

The taxation on the Group's profit before taxation that differs from the theoretical amount that would arise using the taxation rate of Hong Kong is as follows:

	2008 **HK$'m**	2007 HK$'m
Profit before taxation	**4,078**	19,126
Calculated at a taxation rate of 16.5% (2007: 17.5%)	**673**	3,347
Effect of different taxation rates in other countries	**64**	5
Income not subject to taxation	**(295)**	(121)
Expenses not deductible for taxation purposes	**522**	107
Tax losses not recognised	**137**	1
Utilisation of previously unrecognised tax losses	**(17)**	(1)
Over-provision in prior years	**(13)**	(29)
Taxation charge	**1,071**	3,309
Effective tax rate	**26.3%**	17.3 %

17. Profit attributable to equity holders of the Company

The profit of the Company for the year ended 31 December 2008 attributable to equity holders of the Company and dealt with in the financial statements of the Company amounted to HK$1,372 million (2007: HK$14,441 million).

18. Dividends

	2008		2007	
	Per share HK$	**Total HK$'m**	Per share HK$	Total HK$'m
Interim dividend paid	**0.438**	**4,631**	0.428	4,525
Proposed final dividend	**–**	**–**	0.487	5,149
	0.438	**4,631**	0.915	9,674

At a meeting held on 28 August 2008, the Board declared an interim dividend of HK$0.438 per ordinary share for the first half of 2008 amounting to approximately HK$4,631 million.

At a meeting held on 24 March 2009, the Board recommended keeping sufficient funds for operation in the future and does not propose any final dividend for the year ended 31 December 2008.

19. Earnings per share for profit attributable to the equity holders of the Company

The calculation of basic earnings per share is based on the consolidated profit attributable to the equity holders of the Company for the year ended 31 December 2008 of approximately HK$3,343 million (2007: HK$15,446 million) and on the ordinary shares in issue of 10,572,780,266 shares (2007: 10,572,780,266 ordinary shares).

There was no dilution of earnings per share as no potential ordinary shares were in issue for the year ended 31 December 2008 (2007: Nil).

20. Retirement benefit costs

The principal defined contribution schemes for the Group's employees are ORSO schemes exempted under the MPF Schemes Ordinance and the BOC-Prudential Easy Choice MPF Scheme. Under the ORSO schemes, employees make monthly contributions to the ORSO schemes equal to 5% of their basic salaries, while the employer makes monthly contributions equal to 5% to 15% of the employees' monthly basic salaries, depending on years of service. The employees are entitled to receive 100% of the employer's contributions upon termination of employment after completing 20 years of service, or at a scale ranging from 20% to 95% for employees who have completed between 3 to 20 years of service, on conditions of retirement, early retirement, permanent incapacity and ill-health or termination of employment other than summary dismissal.

With the implementation of the MPF Schemes Ordinance on 1 December 2000, the Group also participates in the BOC-Prudential Easy Choice MPF Scheme, of which the trustee is BOCI-Prudential Trustee and the investment manager is BOCI-Prudential Manager, which are related parties of the Company.

The Group's total contributions made to the ORSO schemes for the year ended 31 December 2008 amounted to approximately HK$312 million (2007: approximately HK$261 million), after a deduction of forfeited contributions of approximately HK$10 million (2007: approximately HK$15 million). For the MPF Scheme, the Group contributed approximately HK$38 million (2007: approximately HK$28 million) for the year ended 31 December 2008.

21. Share option schemes

(a) *Share Option Scheme and Sharesave Plan*

The principal terms of the Share Option Scheme and the Sharesave Plan were approved and adopted by written resolutions of all the shareholders of the Company dated 10 July 2002.

The purpose of the Share Option Scheme is to provide the participants with the opportunity to acquire proprietary interests in the Company. The Board may, in its absolute discretion, offer to grant options under the Share Option Scheme to any person as the Board may select. The subscription price for the shares shall be determined on the date of grant by the Board as an amount per share calculated on the basis of established rules. An option may be exercised in whole or in part at any time after the date prescribed by the Board and from time to time as specified in the offer and on or before the termination date prescribed by the Board.

The purpose of the Sharesave Plan is to encourage broad-based employee ownership of the shares of the Company. The amount of the monthly contribution under the savings contract to be made in connection with an option shall be the amount which the relevant eligible employee is willing to contribute, which amount shall not be less than 1% and not more than 10% of the eligible employee's monthly salary as at the date of application or such other maximum or minimum amounts as permitted by the Board. When an option is exercised during an exercise period, it may be exercised in whole or in part.

No options were granted pursuant to the Share Option Scheme or the Sharesave Plan during the year 2008 (2007: Nil).

(b) *Pre-Listing Share Option Scheme*

On 5 July 2002, several directors together with approximately 60 senior management personnel of the Group and employees of BOC were granted options by BOC (BVI), the immediate holding company of the Company, pursuant to a Pre-Listing Share Option Scheme to purchase from BOC (BVI) an aggregate of 31,132,600 existing issued shares of the Company. The Group has taken advantage of the transitional provisions set out in paragraph 53 of HKFRS 2 under which the new recognition and measurement policies have not been applied to all options granted to employees on or before 7 November 2002.

Details of the share options outstanding as at 31 December 2008 are disclosed as follows:

	Directors	**Senior management**	**Others***	**Total number of share options**	**Average exercise price (HK$ per share)**
At 1 January 2008	**6,651,600**	**2,253,100**	**1,446,000**	**10,350,700**	**8.5**
Less: Share options exercised during the year	**(361,500)**	**(891,900)**	**(1,446,000)**	**(2,699,400)**	**8.5**
At 31 December 2008	**6,290,100**	**1,361,200**	**–**	**7,651,300**	**8.5**
Exercisable at 31 December 2008	**6,290,100**	**1,361,200**	**–**	**7,651,300**	**8.5**
At 1 January 2007	8,459,100	3,980,450	1,446,000	13,885,550	8.5
Transfer	(1,446,000)	–	1,446,000	–	8.5
Less: Share options exercised during the year	(361,500)	(1,727,350)	(1,446,000)	(3,534,850)	8.5
At 31 December 2007	6,651,600	2,253,100	1,446,000	10,350,700	8.5
Exercisable at 31 December 2007	6,651,600	2,253,100	1,446,000	10,350,700	8.5

* Represented share options held by ex-directors of the Group.

21. Share option schemes (continued)

(b) Pre-Listing Share Option Scheme (continued)

Share options were exercised on a regular basis throughout the year, the weighted average share price during the year was HK$18.65 (2007: HK$19.38).

The options granted under this scheme can be exercised at HK$8.50 per share in respect of the option price of HK$1.00. These options have a vesting period of four years from the date on which dealings in the shares commenced on the Stock Exchange with a valid exercise period of ten years. No offer to grant any options under the Pre-Listing Share Option Scheme will be made on or after the date on which dealings in the shares commenced on the Stock Exchange.

22. Directors' and senior management's emoluments

(a) Directors' emoluments

Details of the emoluments paid to or receivable by the directors of the Company in respect of their services rendered for the Company and managing the subsidiaries within the Group during the year are as follows:

For the year 2008	Directors' fees HK$'000	Basic salaries, allowances and benefits in kind HK$'000	Contributions to pension schemes HK$'000	Bonus HK$'000	Total HK$'000
Executive Directors					
He Guangbei	100	6,013	–	–	6,113
Lee Raymond Wing Hung	414	6,979	247	–	7,640
Gao Yingxin	100	4,308	–	–	4,408
	614	17,300	247	–	18,161
Non-executive Directors					
Xiao Gang	–	–	–	–	–
Sun Changji	300	–	–	–	300
Li Zaohang	250	–	–	–	250
Zhou Zaiqun	365	–	–	–	365
Zhang Yanling	250	–	–	–	250
Fung Victor Kwok King*	300	–	–	–	300
Koh Beng Seng*	350	–	–	–	350
Shan Weijian*	350	–	–	–	350
Tung Chee Chen*	300	–	–	–	300
Tung Savio Wai-Hok*	350	–	–	–	350
Yang Linda Tsao*	400	–	–	–	400
	3,215	–	–	–	3,215
	3,829	17,300	247	–	21,376

Note: Basic salaries, allowances and benefits in kind for the year 2008 include fixed guaranteed bonus.

22. Directors' and senior management's emoluments (continued)

(a) Directors' emoluments (continued)

For the year 2007	Directors' fees HK$'000	Basic salaries, allowances and benefits in kind HK$'000	Contributions to pension schemes HK$'000	Bonus HK$'000	Total HK$'000
Executive Directors					
He Guangbei	100	5,326	–	3,000	8,426
Lee Raymond Wing Hung**	259	3,044	112	1,339	4,754
Gao Yingxin**	100	2,278	–	1,120	3,498
	459	10,648	112	5,459	16,678
Non-executive Directors					
Xiao Gang	–	–	–	–	–
Sun Changji	300	–	–	–	300
Hua Qingshan	137	–	–	–	137
Li Zaohang	250	–	–	–	250
Zhou Zaiqun	300	–	–	–	300
Zhang Yanling	250	–	–	–	250
Fung Victor Kwok King*	300	–	–	–	300
Koh Beng Seng*	350	–	–	–	350
Shan Weijian*	350	–	–	–	350
Tung Chee Chen*	300	–	–	–	300
Tung Savio Wai-Hok*	350	–	–	–	350
Yang Linda Tsao*	400	–	–	–	400
	3,287	–	–	–	3,287
	3,746	10,648	112	5,459	19,965

Note:

* Independent Non-executive Directors

** The directors were appointed on 25 May 2007, therefore the amounts of their emoluments for 2007 were disclosed on a pro-rata basis.

In July 2002, options were granted to several directors of the Company by the immediate holding company, BOC (BVI), under the Pre-Listing Share Option Scheme as set out in Note 21(b). Full details of the scheme are stated in Note 21. During the year, certain options were exercised, but no benefits arising from the granting of these share options were included in the directors' emoluments disclosed above or recognised in the income statement.

For the year ended 31 December 2008, one of the directors waived emoluments of HK$200,000 (2007: HK$200,000).

22. Directors' and senior management's emoluments (continued)

(b) Five highest paid individuals

The five individuals whose emoluments were the highest in the Group for the year include 2 (2007: 2) directors whose emoluments are reflected in the analysis presented above. The emoluments payable to the remaining 3 (2007: 3) individuals during the year are as follows:

	2008 HK$'m	2007 HK$'m
Basic salaries and allowances	**13**	11
Bonuses	**–**	4
Contributions to pension schemes	**1**	1
Director's fee from subsidiaries	**1**	–
Amount paid as an inducement to join the Group	**–**	4
	15	20

Note: Basic salaries and allowances for the year 2008 include fixed guaranteed bonus.

Emoluments of individuals were within the following bands:

	Number of individuals	
	2008	2007
HK$4,000,001 – HK$4,500,000	**1**	–
HK$4,500,001 – HK$5,000,000	**1**	–
HK$5,500,001 – HK$6,000,000	**1**	1
HK$6,500,001 – HK$7,000,000	**–**	1
HK$7,500,001 – HK$8,000,000	**–**	1

23. Cash and balances with banks and other financial institutions

	2008 HK$'m	2007 HK$'m
Cash	**4,232**	3,334
Balances with central banks	**66,158**	30,627
Balances with banks and other financial institutions	**7,545**	6,139
Placements with banks and other financial institutions maturing within one month	**75,334**	118,965
	153,269	159,065

24. Financial assets at fair value through profit or loss

	Trading securities		Financial assets designated at fair value through profit or loss		Total	
	2008 HK$'m	2007 HK$'m	**2008 HK$'m**	2007 HK$'m	**2008 HK$'m**	2007 HK$'m
At fair value						
Debt securities						
– Listed in Hong Kong	**412**	190	**557**	895	**969**	1,085
– Listed outside Hong Kong	**35**	537	**3,095**	2,687	**3,130**	3,224
	447	727	**3,652**	3,582	**4,099**	4,309
– Unlisted	**13,484**	5,510	**23,855**	21,037	**37,339**	26,547
	13,931	6,237	**27,507**	24,619	**41,438**	30,856
Fund						
– Unlisted	**–**	–	**2,168**	2,814	**2,168**	2,814
Equity securities						
– Listed in Hong Kong	**20**	327	**124**	349	**144**	676
– Unlisted	**62**	94	**–**	–	**62**	94
	82	421	**124**	349	**206**	770
Total	**14,013**	6,658	**29,799**	27,782	**43,812**	34,440

Financial assets at fair value through profit or loss are analysed by type of issuer as follows:

	2008 HK$'m	2007 HK$'m
Sovereigns	**13,082**	4,197
Public sector entities	**1,791**	1,333
Banks and other financial institutions	**25,668**	24,820
Corporate entities	**3,271**	4,090
	43,812	34,440

Financial assets at fair value through profit or loss are analysed as follows:

	2008 HK$'m	2007 HK$'m
Treasury bills	**12,458**	3,517
Certificates of deposit held	**3,569**	3,204
Other financial assets at fair value through profit or loss	**27,785**	27,719
	43,812	34,440

25. Derivative financial instruments and hedge accounting

The Group enters into the following equity, foreign exchange, interest rate and precious metal related derivative financial instruments for trading and risk management purposes:

Currency forwards represent commitments to purchase and sell foreign currency on a future date. Interest rate futures are contractual obligations to receive or pay a net amount based on changes in interest rates or buy or sell interest rate financial instruments on a future date at an agreed price in the financial market under the administration of the stock exchange. Forward rate agreements are individually negotiated interest rate futures that call for a cash settlement at a future date for the difference between a contracted rate of interest and the current market rate, based on a notional principal amount.

Currency, interest rate and precious metal swaps are commitments to exchange one set of cash flows or commodity for another. Swaps result in an exchange of currencies, interest rates (for example, fixed rate for floating rate), or precious metals (for example, silver swaps) or a combination of all these (i.e. cross-currency interest rate swaps). Except for certain currency swap contracts, no exchange of principal takes place.

Foreign currency, interest rate, equity and precious metal 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) at or by a set date or during a set period, a specific amount of the financial instrument at a predetermined price. In consideration for the assumption of foreign exchange and interest rate risk, the seller receives a premium from the purchaser. Options are negotiated over-the-counter ("OTC") between the Group and its counterparty or traded through the stock exchange (for example, exchange-traded stock option).

The contract/notional amounts and fair values of derivative financial instruments held by the Group are set out in the following tables. The contract/notional amounts of these instruments indicate the volume of transactions outstanding at the balance sheet dates and certain of them provide a basis for comparison with fair value instruments recognised on the consolidated balance sheet. However, they do not necessarily indicate the amounts of future cash flows involved or the current fair values of the instruments and, therefore, do not indicate the Group's exposure to credit or market risks. The derivative financial instruments become favourable (assets) or unfavourable (liabilities) as a result of fluctuations in market interest rates, foreign exchange rates or equity and metal prices relative to their terms. The aggregate fair values of derivative financial instruments assets and liabilities can fluctuate significantly from time to time.

(a) Derivative financial instruments

The Group trades derivative products (both exchange-traded or OTC) mainly for customer business. The Group strictly follows risk management policies in providing derivative products to our customers and in trading of derivative products in the interbank market.

Derivatives are also used to manage the interest rate risk of the banking book. A derivative instrument must be included in the approved product list before any transactions for that instrument can be made. There are limits to control the notional amount of exposure arising from derivative transactions, and the maximum tenor of the deal and management alert limit (MAL) in profit and loss is set. Every derivative transaction must be input into the relevant system for settlement, mark to market revaluation, reporting and control.

25. Derivative financial instruments and hedge accounting (continued)

(a) Derivative financial instruments (continued)

The following tables summarise the contract/notional amounts of each significant type of derivative financial instrument as at 31 December:

	2008			
	Trading HK$'m	Hedging HK$'m	Not qualified for hedge accounting* HK$'m	Total HK$'m
Exchange rate contracts				
Spot and forwards	182,624	–	–	182,624
Swaps	248,956	–	68	249,024
Foreign currency option contracts				
– Options purchased	2,518	–	–	2,518
– Options written	2,754	–	–	2,754
	436,852	–	68	436,920
Interest rate contracts				
Futures	4,290	–	–	4,290
Swaps	68,392	19,931	10,045	98,368
Interest rate option contracts				
– Bond options written	775	–	–	775
	73,457	19,931	10,045	103,433
Bullion contracts	3,880	–	–	3,880
Equity contracts	5,070	–	–	5,070
Other contracts	144	–	–	144
Total	519,403	19,931	10,113	549,447

* Derivative transactions which do not qualify as hedges for accounting purposes but are managed in conjunction with the financial instruments designated at fair value through profit or loss are separately disclosed in compliance with the requirements set out in the Banking (Disclosure) Rules.

25. Derivative financial instruments and hedge accounting (continued)

(a) Derivative financial instruments (continued)

	2007			
	Trading HK$'m	Hedging HK$'m	Not qualified for hedge accounting HK$'m	Total HK$'m
Exchange rate contracts				
Spot and forwards	258,556	–	1,495	260,051
Swaps	156,554	–	–	156,554
Foreign currency option contracts				
– Options purchased	5,607	–	–	5,607
– Options written	5,875	–	–	5,875
	426,592	–	1,495	428,087
Interest rate contracts				
Futures	226	–	–	226
Swaps	36,714	6,708	3,253	46,675
Interest rate option contracts				
– Swaptions written	780	–	–	780
– Bond options written	780	–	–	780
	38,500	6,708	3,253	48,461
Bullion contracts	12,950	–	–	12,950
Equity contracts	5,378	–	–	5,378
Other contracts	172	–	–	172
Total	483,592	6,708	4,748	495,048

25. Derivative financial instruments and hedge accounting (continued)

(a) Derivative financial instruments (continued)

The following tables summarise the fair values of each class of derivative financial instrument as at 31 December:

	2008							
	Fair value assets				Fair value liabilities			
	Trading HK$'m	Hedging HK$'m	Not qualified for hedge accounting HK$'m	Total HK$'m	Trading HK$'m	Hedging HK$'m	Not qualified for hedge accounting HK$'m	Total HK$'m
Exchange rate contracts								
Spot and forwards	15,152	–	–	15,152	(10,962)	–	–	(10,962)
Swaps	1,624	–	1	1,625	(3,933)	–	(3)	(3,936)
Foreign currency option contracts								
– Options purchased	21	–	–	21	–	–	–	–
– Options written	–	–	–	–	(24)	–	–	(24)
	16,797	–	1	16,798	(14,919)	–	(3)	(14,922)
Interest rate contracts								
Futures	2	–	–	2	(6)	–	–	(6)
Swaps	1,420	–	18	1,438	(2,329)	(1,769)	(166)	(4,264)
Interest rate option contracts								
– Bond options written	–	–	–	–	(25)	–	–	(25)
	1,422	–	18	1,440	(2,360)	(1,769)	(166)	(4,295)
Bullion contracts	248	–	–	248	(91)	–	–	(91)
Equity contracts	1,142	–	–	1,142	(1,142)	–	–	(1,142)
Total	19,609	–	19	19,628	(18,512)	(1,769)	(169)	(20,450)

25. Derivative financial instruments and hedge accounting (continued)

(a) Derivative financial instruments (continued)

	2007							
	Fair value assets				Fair value liabilities			
	Trading HK$'m	Hedging HK$'m	Not qualified for hedge accounting HK$'m	Total HK$'m	Trading HK$'m	Hedging HK$'m	Not qualified for hedge accounting HK$'m	Total HK$'m
Exchange rate contracts								
Spot and forwards	12,588	–	–	12,588	(7,822)	–	(10)	(7,832)
Swaps	269	–	–	269	(634)	–	–	(634)
Foreign currency option contracts								
– Options purchased	48	–	–	48	–	–	–	–
– Options written	–	–	–	–	(51)	–	–	(51)
	12,905	–	–	12,905	(8,507)	–	(10)	(8,517)
Interest rate contracts								
Swaps	492	10	23	525	(885)	(124)	(90)	(1,099)
Interest rate option contracts								
– Swaptions written	–	–	–	–	(17)	–	–	(17)
– Bond options written	–	–	–	–	(23)	–	–	(23)
	492	10	23	525	(925)	(124)	(90)	(1,139)
Bullion contracts	774	–	–	774	(1,110)	–	–	(1,110)
Equity contracts	273	–	–	273	(326)	–	–	(326)
Total	14,444	10	23	14,477	(10,868)	(124)	(100)	(11,092)

25. Derivative financial instruments and hedge accounting (continued)

(a) *Derivative financial instruments (continued)*

The credit risk weighted amounts of the above derivative financial instruments are as follows:

	2008 HK$'m	2007 HK$'m
Exchange rate contracts		
Forwards	**318**	1,017
Swaps	**1,377**	492
Foreign currency option contracts		
– Options purchased	**4**	19
Interest rate contracts		
Futures	**2**	–
Swaps	**577**	104
Bullion contracts	**5**	63
Equity contracts	**37**	49
	2,320	1,744

The credit risk weighted amounts are the amounts that have been calculated in accordance with the Banking (Capital) Rules. The amounts calculated are dependent upon the status of the counterparty and the maturity characteristics of each type of contract.

There is no effect of valid bilateral netting agreement on the fair values or the credit risk-weighted amounts of the derivative financial instruments.

Approximately 69% (2007: 52%) of the Group's transactions in derivative contracts are conducted with other financial institutions.

(b) *Hedge accounting*

The Group designated all derivatives held for hedging as fair value hedges.

The Group uses interest rate swaps to hedge against change in fair value of financial assets arising from movements in market rates.

Gains or losses on fair value hedges for the year are as follows:

	2008 HK$'m	2007 HK$'m
Net gain/(loss) on		
– hedging instruments	**(1,656)**	(125)
– hedged items	**1,677**	114
	21	(11)

26. Advances and other accounts

	2008 HK$'m	2007 HK$'m
Personal loans and advances	**151,784**	141,708
Corporate loans and advances	**308,663**	271,354
Advances to customers	**460,447**	413,062
Loan impairment allowances		
– Individually assessed	**(800)**	(381)
– Collectively assessed	**(1,501)**	(1,004)
	458,146	411,677
Trade bills	**7,609**	5,334
Advances to banks and other financial institutions	**3,738**	3,223
Total	**469,493**	420,234

As at 31 December 2008, advances to customers included accrued interest on gross advances of HK$1,293 million (2007: HK$1,454 million).

As at 31 December 2008 and 2007, no impairment allowance was made in respect of trade bills and advances to banks and other financial institutions.

27. Loan impairment allowances

	2008		
	Individual assessment		
	Personal HK$'m	Corporate HK$'m	Total HK$'m
At 1 January 2008	**82**	**299**	**381**
(Credited)/charged to income statement (Note 12)	**(30)**	**38**	**8**
Loans written off during the year as uncollectible	**(13)**	**(286)**	**(299)**
Recoveries	**33**	**689**	**722**
Unwind of discount on allowance	**(1)**	**(11)**	**(12)**
At 31 December 2008	**71**	**729**	**800**

	2008		
	Collective assessment		
	Personal HK$'m	Corporate HK$'m	Total HK$'m
At 1 January 2008	**173**	**831**	**1,004**
Charged to income statement (Note 12)	**156**	**497**	**653**
Loans written off during the year as uncollectible	**(175)**	**(1)**	**(176)**
Recoveries	**28**	**–**	**28**
Unwind of discount on allowance	**(3)**	**(5)**	**(8)**
At 31 December 2008	**179**	**1,322**	**1,501**

27. Loan impairment allowances (continued)

	2007		
	Individual assessment		
	Personal HK$'m	Corporate HK$'m	Total HK$'m
At 1 January 2007	117	429	546
Credited to income statement (Note 12)	(52)	(1,228)	(1,280)
Loans written off during the year as uncollectible	(27)	(145)	(172)
Recoveries	50	1,261	1,311
Unwind of discount on allowance	(6)	(18)	(24)
At 31 December 2007	82	299	381

	2007		
	Collective assessment		
	Personal HK$'m	Corporate HK$'m	Total HK$'m
At 1 January 2007	107	450	557
Charged to income statement (Note 12)	197	398	595
Loans written off during the year as uncollectible	(155)	–	(155)
Recoveries	30	–	30
Unwind of discount on allowance	(6)	(17)	(23)
At 31 December 2007	173	831	1,004

28. Investment in securities

	2008 HK$'m	2007 HK$'m
The Group		
(a) Available-for-sale securities		
Debt securities, at fair value		
– Listed in Hong Kong	**4,588**	3,659
– Listed outside Hong Kong	**44,692**	18,455
	49,280	22,114
– Unlisted	**121,655**	77,959
	170,935	100,073
Equity securities, at fair value		
– Listed in Hong Kong	**1,256**	4,135
– Unlisted	**430**	445
	1,686	4,580
	172,621	104,653
(b) Held-to-maturity securities		
Listed, at amortised cost		
– in Hong Kong	**4,082**	4,107
– outside Hong Kong	**21,302**	21,078
	25,384	25,185
Unlisted, at amortised cost	**85,521**	141,925
	110,905	167,110
Impairment allowances	**(4,440)**	(1,682)
	106,465	165,428
(c) Loans and receivables		
Unlisted, at amortised cost	**12,595**	31,102
Total	**291,681**	301,183
Market value of listed held-to-maturity securities	**24,354**	24,776

	2008 HK$'m	2007 HK$'m
The Company		
Available-for-sale securities		
Equity securities, at fair value		
– Listed in Hong Kong	**1,256**	4,135

28. Investment in securities (continued)

Investment in securities is analysed by type of issuer as follows:

	2008			
	Available-for-sale securities HK$'m	**Held-to-maturity securities HK$'m**	**Loans and receivables HK$'m**	**Total HK$'m**
The Group				
Sovereigns	**70,274**	**1,079**	**–**	**71,353**
Public sector entities	**9,202**	**12,481**	**–**	**21,683**
Banks and other financial institutions	**71,832**	**72,498**	**12,595**	**156,925**
Corporate entities	**21,313**	**20,407**	**–**	**41,720**
	172,621	**106,465**	**12,595**	**291,681**

	2007			
	Available-for-sale securities HK$'m	Held-to-maturity securities HK$'m	Loans and receivables HK$'m	Total HK$'m
The Group				
Sovereigns	13,402	1,814	–	15,216
Public sector entities	9,673	20,530	–	30,203
Banks and other financial institutions	47,989	108,547	31,102	187,638
Corporate entities	33,589	34,537	–	68,126
	104,653	165,428	31,102	301,183

As at 31 December 2008 and 2007, all of the available-for-sale securities held by the Company are issued by banks and other financial institutions.

The movements in investment in securities are summarised as follows:

	2008		
	Available-for-sale securities HK$'m	**Held-to-maturity securities HK$'m**	**Loans and receivables HK$'m**
The Group			
At 1 January 2008	**104,653**	**165,428**	**31,102**
Additions	**182,457**	**57,186**	**33,918**
Disposals, redemptions and maturity	**(101,229)**	**(106,014)**	**(52,627)**
Amortisation	**544**	**(1,035)**	**640**
Change in fair value	**(10,570)**	**–**	**–**
Impairment losses	**–**	**(4,061)**	**–**
Exchange differences	**(3,234)**	**(5,039)**	**(438)**
At 31 December 2008	**172,621**	**106,465**	**12,595**

28. Investment in securities (continued)

	2007		
	Available-for-sale securities HK$'m	Held-to-maturity securities HK$'m	Loans and receivables HK$'m
The Group			
At 1 January 2007	100,389	165,588	36,114
Additions	107,581	93,912	59,147
Disposals, redemptions and maturity	(104,590)	(94,989)	(65,713)
Amortisation	378	225	1,472
Change in fair value	(654)	–	–
Impairment losses	–	(1,844)	–
Exchange differences	1,549	2,536	82
At 31 December 2007	104,653	165,428	31,102

	Available-for-sale securities	
	2008 HK$'m	2007 HK$'m
The Company		
At 1 January	**4,135**	–
Additions	**–**	3,986
Change in fair value	**(2,879)**	149
At 31 December	**1,256**	4,135

Available-for-sale and held-to-maturity securities are analysed as follows:

	Available-for-sale securities		Held-to-maturity securities	
	2008 HK$'m	2007 HK$'m	**2008 HK$'m**	2007 HK$'m
The Group				
Treasury bills	**60,980**	9,396	**100**	200
Certificates of deposit held	**7,355**	7,466	**12,448**	11,988
Others	**104,286**	87,791	**93,917**	153,240
	172,621	104,653	**106,465**	165,428

28. Investment in securities (continued)

The movements in impairment allowances on held-to-maturity securities are summarised as follows:

	2008 HK$'m	2007 HK$'m
The Group		
At 1 January	**1,682**	–
Charged to income statement (Note 12)	**4,061**	1,844
Disposals	**(1,303)**	(162)
At 31 December	**4,440**	1,682

29. Investment in subsidiaries

	2008 HK$'m	2007 HK$'m
Unlisted shares, at cost	**54,019**	53,764

The particulars of all direct and indirect subsidiaries of the Company are set out in the Appendix of the Annual Report, "Subsidiaries of the Company". The following is a list of principal subsidiaries as at 31 December 2008:

Name	Country of incorporation & place of operation	Particulars of issued share capital	Interest held	Principal activities
Bank of China (Hong Kong) Limited	Hong Kong	43,042,840,858 ordinary shares of HK$1 each	*100%	Banking business
BOC Group Life Assurance Company Limited	Hong Kong	136,800,000 ordinary shares of HK$10 each	*51%	Life insurance business
Nanyang Commercial Bank, Limited	Hong Kong	6,000,000 ordinary shares of HK$100 each	100%	Banking business
Chiyu Banking Corporation Limited	Hong Kong	3,000,000 ordinary shares of HK$100 each	70.49%	Banking business
BOC Credit Card (International) Limited	Hong Kong	4,800,000 ordinary shares of HK$100 each	100%	Credit card services
Po Sang Futures Limited	Hong Kong	250,000 ordinary shares of HK$100 each	100%	Commodities brokerage

* Shares held directly by the Company

30. Interests in associates

	2008 **HK$'m**	2007 HK$'m
At 1 January	**83**	60
Investment cost addition	**–**	24
Share of result	**9**	4
Share of tax	**(2)**	(1)
Dividends received	**(2)**	(3)
Dissolution of an associate	**–**	(1)
At 31 December	**88**	83

The Group's interests in its associates, all of which are unlisted, are as follows:

Name	**CJM Insurance Brokers Limited**		**Joint Electronic Teller Services Limited**		**BOC Services Company Limited**	
Place of incorporation	**2008** and 2007 **Hong Kong**		**2008** and 2007 **Hong Kong**		**2008** and 2007 **PRC**	
Particulars of issued share capital/registered capital	**6,000,000 ordinary shares of HK$1 each**		**100,238 ordinary shares of HK$100 each**		**Registered capital RMB50,000,000**	
Principal activities	**Insurance broker**		**Operation of a private inter-bank message switching network in respect of ATM services**		**Credit card back-end service support**	
	2008 HK$'000	2007 HK$'000	**2008 HK$'000**	2007 HK$'000	**2008 HK$'000**	2007 HK$'000
Assets	**47,846**	64,331	**371,144**	354,104	**108,145**	53,677
Liabilities	**35,310**	51,815	**86,283**	77,593	**45,250**	–
Revenues	**11,389**	10,330	**75,297**	70,033	**118,274**	–
Profit after taxation	**1,519**	1,481	**34,752**	33,649	**5,166**	–
	2008	2007	**2008**	2007	**2008**	2007
Interest held	**33.33%**	33.33%	**19.96%**	19.96%	**45.00%**	45.00%

31. Investment properties

	2008 HK$'m	2007 HK$'m
At 1 January	**8,058**	7,481
Disposals	**(186)**	(200)
Fair value (losses)/gains (Note 14)	**(132)**	1,056
Reclassification to properties, plant and equipment (Note 32)	**(13)**	(279)
At 31 December	**7,727**	8,058

As at 31 December 2008, investment properties are included in the consolidated balance sheet at valuation carried out at 31 December 2008 on the basis of their fair value by an independent firm of chartered surveyors, Knight Frank Petty Limited.

The carrying value of investment properties is analysed based on the remaining terms of the leases as follows:

	2008 HK$'m	2007 HK$'m
Held in Hong Kong		
On long-term lease (over 50 years)	**7,040**	7,251
On medium-term lease (10 – 50 years)	**505**	528
On short-term lease (less than 10 years)	**–**	48
Held outside Hong Kong		
On long-term lease (over 50 years)	**1**	3
On medium-term lease (10 – 50 years)	**177**	224
On short-term lease (less than 10 years)	**4**	4
	7,727	8,058

32. Properties, plant and equipment

	Premises HK$'m	Equipment, fixtures and fittings HK$'m	Total HK$'m
Net book value at 1 January 2008	**20,783**	**2,510**	**23,293**
Additions	**42**	**776**	**818**
Disposals	**(68)**	**(5)**	**(73)**
Revaluation	**(265)**	**–**	**(265)**
Depreciation for the year (Note 13)	**(400)**	**(592)**	**(992)**
Reclassification from investment properties (Note 31)	**13**	**–**	**13**
Exchange difference	**–**	**1**	**1**
Net book value at 31 December 2008	**20,105**	**2,690**	**22,795**
At 31 December 2008			
Cost or valuation	**20,105**	**6,239**	**26,344**
Accumulated depreciation and impairment	**–**	**(3,549)**	**(3,549)**
Net book value at 31 December 2008	**20,105**	**2,690**	**22,795**
Net book value at 1 January 2007	17,906	1,834	19,740
Additions	–	1,147	1,147
Disposals	(16)	(17)	(33)
Revaluation	2,946	–	2,946
Depreciation for the year (Note 13)	(332)	(455)	(787)
Reclassification from investment properties (Note 31)	279	–	279
Exchange difference	–	1	1
Net book value at 31 December 2007	20,783	2,510	23,293
At 31 December 2007			
Cost or valuation	20,783	5,642	26,425
Accumulated depreciation and impairment	–	(3,132)	(3,132)
Net book value at 31 December 2007	20,783	2,510	23,293
The analysis of cost or valuation of the above assets is as follows:			
At 31 December 2008			
At cost	**–**	**6,239**	**6,239**
At valuation	**20,105**	**–**	**20,105**
	20,105	**6,239**	**26,344**
At 31 December 2007			
At cost	–	5,642	5,642
At valuation	20,783	–	20,783
	20,783	5,642	26,425

32. Properties, plant and equipment (continued)

The carrying value of premises is analysed based on the remaining terms of the leases as follows:

	2008 HK$'m	2007 HK$'m
Held in Hong Kong		
On long-term lease (over 50 years)	**12,825**	12,955
On medium-term lease (10 – 50 years)	**6,873**	7,584
Held outside Hong Kong		
On long-term lease (over 50 years)	**75**	57
On medium-term lease (10 – 50 years)	**306**	170
On short-term lease (less than 10 years)	**26**	17
	20,105	20,783

As at 31 December 2008, premises are included in the consolidated balance sheet at valuation carried out at 31 December 2008 on the basis of their fair value by an independent firm of chartered surveyors, Knight Frank Petty Limited.

As a result of the above-mentioned revaluations, changes in value of the Group's premises were recognised in the Group's premises revaluation reserve, the income statement and minority interests respectively as follows:

	2008 HK$'m	2007 HK$'m
(Decrease)/increase in valuation (charged)/credited to premises revaluation reserve	**(250)**	2,910
(Decrease)/increase in valuation (charged)/credited to income statement (Note 15)	**(24)**	19
Increase in valuation credited to minority interests	**9**	17
	(265)	2,946

As at 31 December 2008, the net book value of premises that would have been included in the Group's consolidated balance sheet had the assets been carried at cost less accumulated depreciation and impairment losses was HK$6,123 million (2007: HK$6,072 million).

33. Other assets

	2008 HK$'m	2007 HK$'m
Repossessed assets	**124**	76
Precious metals	**1,347**	1,741
Accounts receivable and prepayments	**13,208**	19,040
	14,679	20,857

34. Hong Kong SAR currency notes in circulation

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

35. Financial liabilities at fair value through profit or loss

	2008 HK$'m	2007 HK$'m
Trading liabilities		
– Short positions in Exchange Fund Bills (Note 38)	**12,141**	3,492
Financial liabilities designated at fair value through profit or loss		
– Structured deposits (Note 36)	**8,939**	5,959
– Certificates of deposit issued	**858**	1,954
	9,797	7,913
	21,938	11,405

The carrying amount of financial liabilities designated at fair value through profit or loss as at 31 December 2008 is more than the amount that the Group would be contractually required to pay at maturity to the holders by HK$5 million, and it was less than the amount that the Group would be contractually required to pay at maturity to the holders by HK$44 million as at 31 December 2007. The amount of change in the fair values of financial liabilities at fair value through profit or loss, during the year and cumulatively, attributable to changes in credit risk is insignificant.

36. Deposits from customers

	2008 HK$'m	2007 HK$'m
Current, savings and other deposit accounts (per consolidated balance sheet)	**802,577**	793,606
Structured deposits reported as financial liabilities at fair value through profit or loss (Note 35)	**8,939**	5,959
	811,516	799,565
Analysed by:		
Demand deposits and current accounts		
– corporate customers	**35,867**	32,645
– individual customers	**10,175**	7,854
	46,042	40,499
Savings deposits		
– corporate customers	**115,918**	76,668
– individual customers	**261,355**	209,985
	377,273	286,653
Time, call and notice deposits		
– corporate customers	**150,526**	172,342
– individual customers	**237,675**	300,071
	388,201	472,413
	811,516	799,565

37. Other accounts and provisions

	2008 HK$'m	2007 HK$'m
Other accounts payable	**34,297**	33,335
Provisions	**576**	9
	34,873	33,344

38. Assets pledged as security

As at 31 December 2008, liabilities of the Group amounting to HK$12,141 million (2007: HK$3,492 million) were secured by assets deposited with central depositories to facilitate settlement operations. The amount of assets pledged by the Group to secure these liabilities was HK$12,243 million (2007: HK$3,836 million) included in "Trading securities" and "Available-for-sale securities".

39. Deferred taxation

Deferred tax is recognised in respect of the temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements in accordance with HKAS 12 "Income Taxes".

The major components of deferred tax assets and liabilities recorded in the consolidated balance sheet, and the movements during the year are as follows:

	2008					
	Accelerated tax depreciation HK$'m	**Asset revaluation HK$'m**	**Losses HK$'m**	**Impairment allowance HK$'m**	**Other temporary differences HK$'m**	**Total HK$'m**
At 1 January 2008	**533**	**3,777**	**(15)**	**(169)**	**(182)**	**3,944**
Charged/(credited) to income statement (Note 16)	**12**	**(205)**	**(111)**	**(85)**	**(75)**	**(464)**
Credited to equity and minority interests	**–**	**(108)**	**–**	**–**	**(727)**	**(835)**
At 31 December 2008	**545**	**3,464**	**(126)**	**(254)**	**(984)**	**2,645**

	2007					
	Accelerated tax depreciation HK$'m	Asset revaluation HK$'m	Losses HK$'m	Impairment allowance HK$'m	Other temporary differences HK$'m	Total HK$'m
At 1 January 2007	401	3,155	(71)	(89)	(74)	3,322
Charged/(credited) to income statement (Note 16)	132	143	56	(80)	1	252
Charged/(credited) to equity and minority interests	–	479	–	–	(109)	370
At 31 December 2007	533	3,777	(15)	(169)	(182)	3,944

39. Deferred taxation (continued)

Deferred tax assets and liabilities are offset on an individual entity basis when there is a legal right to set off current tax assets against current tax liabilities and when the deferred taxation relates to the same authority. The following amounts, determined after appropriate offsetting, are shown in the consolidated balance sheet:

	2008 **HK$'m**	2007 HK$'m
Deferred tax assets	**(154)**	(23)
Deferred tax liabilities	**2,799**	3,967
	2,645	3,944

	2008 **HK$'m**	2007 HK$'m
Deferred tax assets to be recovered after more than twelve months	**(154)**	(23)
Deferred tax liabilities to be settled after more than twelve months	**3,762**	4,115
	3,608	4,092

The deferred tax (credited)/charged to equity during the year is as follows:

	2008 **HK$'m**	2007 HK$'m
Fair value reserves in shareholders' equity:		
– premises	**(109)**	476
– available-for-sale securities	**(727)**	(109)
– minority interests	**1**	3
	(835)	370

40. Insurance contract liabilities

	2008 **HK$'m**	2007 HK$'m
Gross and net		
At 1 January	**22,497**	14,239
Benefits paid	**(1,359)**	(881)
Claims incurred and movement in liabilities	**7,136**	9,139
At 31 December	**28,274**	22,497

41. Subordinated liabilities

			Carrying amount at 31 December	
Principal amount	Interest rate	Due date	**2008 HK$'m**	2007 HK$'m
Subordinated loans				
EUR 660m	6-month EURIBOR + 0.85%*	June 2018	**7,210**	–
USD2,500m	6-month LIBOR + 2.00%**	December 2018	**19,394**	–
HKD735m	3-month HIBOR + 3.00%***	October 2013	**735**	–
			27,339	–

During 2008, the Group obtained floating-rate subordinated loans from BOC, the intermediate holding company. The EUR 660 million and USD2,500 million subordinated loans are repayable prior to maturity after the first 5-year tenure at the option of the borrower. Amounts qualified as supplementary capital for regulatory purposes as shown in Note 4.5(b).

* 6-month EURIBOR plus 0.85% for the first 5 years, 6-month EURIBOR plus 1.35% for the remaining tenure payable semi-annually.

** 6-month LIBOR plus 2.00% for the first 5 years, 6-month LIBOR plus 2.50% for the remaining tenure payable semi-annually.

*** 3-month HIBOR plus 3.00% for the 5 year tenure payable quarterly.

42. Share capital

	2008 HK$'m	2007 HK$'m
Authorised: 20,000,000,000 ordinary shares of HK$5 each	**100,000**	100,000
Issued and fully paid: 10,572,780,266 ordinary shares of HK$5 each	**52,864**	52,864

43. Reserves

The Group's and the Company's reserves and the movements therein for the current and prior years are presented in the consolidated statement of changes in equity and statement of changes in equity respectively on pages 97 to 99 of the financial statements.

44. Notes to consolidated cash flow statement

(a) Reconciliation of operating profit to operating cash inflow before taxation

	2008 HK$'m	2007 HK$'m
Operating profit	**4,182**	18,033
Depreciation	**992**	787
Net charge of impairment allowances	**12,573**	1,448
Unwind of discount on impairment	**(20)**	(47)
Advances written off net of recoveries	**275**	1,014
Interest expense on subordinated liabilities	**250**	–
Change in cash and balances with banks and other financial institutions with original maturity over three months	**7,781**	(27,873)
Change in placements with banks and other financial institutions with original maturity over three months	**(26,893)**	(2,613)
Change in financial assets at fair value through profit or loss	**(1,096)**	(5,297)
Change in derivative financial instruments	**4,207**	(44)
Change in advances and other accounts	**(50,175)**	(67,658)
Change in investment in securities	**(3,954)**	1,053
Change in other assets	**6,166**	(6,317)
Change in deposits and balances of banks and other financial institutions	**28,180**	11,565
Change in financial liabilities at fair value through profit or loss	**10,533**	(3,722)
Change in deposits from customers	**8,971**	98,915
Change in debt securities in issue at amortised cost	**(1,047)**	2,089
Change in other accounts and provisions	**1,529**	7,443
Change in insurance contract liabilities	**5,777**	8,258
Exchange difference	**(728)**	13
Operating cash inflow before taxation	**7,503**	37,047
Cash flows from operating activities included:		
– Interest received	**36,379**	44,927
– Interest paid	**15,206**	27,023
– Dividend received	**126**	15

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

	2008 HK$'m	2007 HK$'m
Cash and balances with banks and other financial institutions with original maturity within three months	**128,004**	126,019
Placements with banks and other financial institutions with original maturity within three months	**23,610**	13,939
Treasury bills with original maturity within three months	**22,277**	10,244
Certificates of deposit held with original maturity within three months	**1,035**	1,868
	174,926	152,070

45. Contingent liabilities and commitments

The following is a summary of the contractual amounts of each significant class of contingent liability and commitment and the corresponding aggregate credit risk weighted amount:

	2008 HK$'m	2007 HK$'m
Direct credit substitutes	**1,419**	2,120
Transaction-related contingencies	**10,153**	7,075
Trade-related contingencies	**22,481**	29,081
Commitments that are unconditionally cancellable without prior notice	**103,684**	50,034
Other commitments with an original maturity of		
– up to one year	**63,252**	84,804
– over one year	**52,400**	58,189
	253,389	231,303
Credit risk weighted amount	**40,251**	47,356

The calculation basis of credit risk weighted amount has been set out in Note 25 to the financial statements.

46. Capital commitments

The Group has the following outstanding capital commitments not provided for in the financial statements:

	2008 HK$'m	2007 HK$'m
Authorised and contracted for but not provided for	**121**	165
Authorised but not contracted for	**15**	1
	136	166

The above capital commitments mainly relate to commitments to purchase computer equipment and software, and to renovate the Group's premises.

47. Operating lease commitments

(a) The Group as lessee

The Group has commitments to make the following future minimum lease payments under non-cancellable operating leases:

	2008 HK$'m	2007 HK$'m
Land and buildings		
– not later than one year	**427**	321
– later than one year but not later than five years	**531**	297
– later than five years	**14**	–
	972	618

Certain non-cancellable operating leases included in the tables above were subject to renegotiation and rent adjustment with reference to market rates prevailing at specified agreed dates.

47. Operating lease commitments (continued)

(b) The Group as lessor

The Group has contracted with tenants for the following future minimum lease receivables under non-cancellable operating leases:

	2008 HK$'m	2007 HK$'m
Land and buildings		
– not later than one year	**270**	251
– later than one year but not later than five years	**234**	215
	504	466

The Group leases its investment properties (Note 31) under operating lease arrangements, with leases typically for a period from one to three years. The terms of the leases generally require the tenants to pay security deposits and provide for periodic rent adjustments according to the prevailing market conditions. None of the leases includes contingent rentals.

48. Litigation

The Group is currently being served a number of claims and counterclaims by various independent parties. These claims and counterclaims are in relation to the normal commercial activities of the Group.

No material provision was made against these claims and counterclaims because the directors believe that the Group has meritorious defences against the claimants or the amounts involved in these claims are not expected to be material.

49. Segmental reporting

The Group engages in many businesses in several regions. For segmental reporting purposes, information is solely provided in respect of business segments. Geographical segment information is not presented because over 90% of the Group's revenues, profits before tax and assets are derived from Hong Kong.

Information about four business segments is provided in segmental reporting. They are Personal Banking, Corporate Banking, Treasury and Insurance.

Both Personal Banking and Corporate Banking segments provide general banking services. Personal Banking serves individual customers while Corporate Banking deals with non individual customers. The Treasury segment is responsible for managing the capital, liquidity, and the interest rate and foreign exchange positions of the Group in addition to proprietary trades. The Insurance segment shows business relates to the Group's long-term life insurance products, including traditional and linked individual life insurance and group life insurance products. "Others" refers to those items related to the Group as a whole but independent of the other four business segments, including the Group's holdings of premises, investment properties, equity investments and interests in associates.

Revenues, expenses, assets and liabilities of any business segment mainly include items directly attributable to the segment. In relation to occupation of the Group's premises, rentals are internally charged on market rates according to the areas occupied. For management overheads, allocations are made on reasonable bases. Inter-segment funding is charged according to the internal funds transfer pricing mechanism of the Group. The charge on any such funding is mainly made by reference to the corresponding money market rate.

49. Segmental reporting (continued)

	2008							
	Personal HK$'m	Corporate HK$'m	Treasury HK$'m	Insurance HK$'m	Others HK$'m	Subtotal HK$'m	Eliminations HK$'m	Consolidated HK$'m
Net interest (expenses)/income								
– external	(3,241)	6,924	15,322	1,122	30	20,157	–	20,157
– inter-segment	9,752	(975)	(8,144)	–	(633)	–	–	–
	6,511	5,949	7,178	1,122	(603)	20,157	–	20,157
Net fees and commission income/(expenses)	3,597	2,032	(95)	(277)	35	5,292	(113)	5,179
Net trading income/(expenses)	548	186	1,298	–	(119)	1,913	1	1,914
Net loss on financial instruments designated at fair value through profit or loss	–	–	(316)	(136)	–	(452)	–	(452)
Net loss on investment in securities	–	–	(15)	–	–	(15)	–	(15)
Net insurance premium income	–	–	–	5,899	–	5,899	(8)	5,891
Other operating income	34	44	7	17	1,829	1,931	(1,370)	561
Total operating income	10,690	8,211	8,057	6,625	1,142	34,725	(1,490)	33,235
Net insurance benefits and claims	–	–	–	(7,709)	–	(7,709)	–	(7,709)
Net operating income/(expense) before impairment allowances	10,690	8,211	8,057	(1,084)	1,142	27,016	(1,490)	25,526
Net charge of impairment allowances	(129)	(544)	(9,170)	–	(2,730)	(12,573)	–	(12,573)
Net operating income/(expense)	10,561	7,667	(1,113)	(1,084)	(1,588)	14,443	(1,490)	12,953
Operating expenses	(5,669)	(2,143)	(831)	(147)	(1,471)	(10,261)	1,490	(8,771)
Operating profit/(loss)	4,892	5,524	(1,944)	(1,231)	(3,059)	4,182	–	4,182
Net loss from disposal of/fair value adjustments on investment properties	–	–	–	–	(118)	(118)	–	(118)
Net gain from disposal/revaluation of properties, plant and equipment	–	–	–	–	7	7	–	7
Share of profits less losses of associates	–	–	–	–	7	7	–	7
Profit/(loss) before taxation	4,892	5,524	(1,944)	(1,231)	(3,163)	4,078	–	4,078
Assets								
Segment assets	165,148	324,606	603,965	31,703	32,016	1,157,438	(10,844)	1,146,594
Interests in associates	–	–	–	–	88	88	–	88
Unallocated corporate assets	–	–	–	–	562	562	–	562
	165,148	324,606	603,965	31,703	32,666	1,158,088	(10,844)	1,147,244
Liabilities								
Segment liabilities	523,682	309,254	203,481	30,977	1,447	1,068,841	(10,844)	1,057,997
Unallocated corporate liabilities	–	–	–	–	4,715	4,715	–	4,715
	523,682	309,254	203,481	30,977	6,162	1,073,556	(10,844)	1,062,712
Other information								
Additions of properties, plant and equipment	12	5	–	5	796	818	–	818
Depreciation	271	132	108	3	478	992	–	992
Amortisation of securities	–	–	149	–	–	149	–	149

49. Segmental reporting (continued)

	2007							
	Personal HK$'m	Corporate HK$'m	Treasury HK$'m	Insurance HK$'m	Others HK$'m	Subtotal HK$'m	Eliminations HK$'m	Consolidated HK$'m
Net interest (expenses)/income								
– external	(8,552)	5,067	22,015	788	77	19,395	–	19,395
– inter-segment	16,696	672	(16,146)	–	(1,222)	–	–	–
	8,144	5,739	5,869	788	(1,145)	19,395	–	19,395
Net fees and commission income/(expenses)	4,983	1,778	47	(307)	(116)	6,385	(111)	6,274
Net trading income	538	151	236	–	87	1,012	1	1,013
Net (loss)/gain on financial instruments designated at fair value through profit or loss	–	–	(25)	893	–	868	–	868
Net loss on investment in securities	–	–	(53)	–	–	(53)	–	(53)
Net insurance premium income	–	–	–	8,429	–	8,429	(3)	8,426
Other operating income	410	1	1	15	1,688	2,115	(1,344)	771
Total operating income	14,075	7,669	6,075	9,818	514	38,151	(1,457)	36,694
Net insurance benefits and claims	–	–	–	(9,440)	–	(9,440)	–	(9,440)
Net operating income before impairment allowances	14,075	7,669	6,075	378	514	28,711	(1,457)	27,254
Net (charge)/reversal of impairment allowances	(112)	797	(2,133)	–	–	(1,448)	–	(1,448)
Net operating income	13,963	8,466	3,942	378	514	27,263	(1,457)	25,806
Operating expenses	(5,829)	(1,940)	(627)	(117)	(717)	(9,230)	1,457	(7,773)
Operating profit/(loss)	8,134	6,526	3,315	261	(203)	18,033	–	18,033
Net gain from disposal of/fair value adjustments on investment properties	–	–	–	–	1,064	1,064	–	1,064
Net (loss)/gain from disposal/revaluation of properties, plant and equipment	(5)	–	–	–	31	26	–	26
Share of profits less losses of associates	–	–	–	–	3	3	–	3
Profit before taxation	8,129	6,526	3,315	261	895	19,126	–	19,126
Assets								
Segment assets	162,634	281,680	566,661	24,545	37,567	1,073,087	(5,771)	1,067,316
Interests in associates	–	–	–	–	83	83	–	83
Unallocated corporate assets	–	–	–	–	238	238	–	238
	162,634	281,680	566,661	24,545	37,888	1,073,408	(5,771)	1,067,637
Liabilities								
Segment liabilities	545,397	284,353	116,095	23,182	2,539	971,566	(5,771)	965,795
Unallocated corporate liabilities	–	–	–	–	6,784	6,784	–	6,784
	545,397	284,353	116,095	23,182	9,323	978,350	(5,771)	972,579
Other information								
Additions of properties, plant and equipment	14	8	–	2	1,123	1,147	–	1,147
Depreciation	234	90	56	2	405	787	–	787
Amortisation of securities	–	–	2,075	–	–	2,075	–	2,075

50. Loans to directors and officers

Particulars of advances made to directors and officers of the Company pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

	2008 **HK$'m**	2007 HK$'m
Aggregate amount of relevant loans outstanding at year end	**655**	622
Maximum aggregate amount of relevant loans outstanding during the year	**667**	839

51. Significant related party transactions

Related parties are those parties that have the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control. Related parties may be individuals or other entities.

The Group provides loans and credit facilities to related parties in the normal course of business. Such transactions are conducted with terms that are no more favourable than those contracted with third party customers of the Group.

Transactions with related parties, which the Group entered into during the year are summarised as follows:

(a) Advances to third parties guaranteed by BOC group companies

As at 31 December 2008, BOC, the intermediate holding company, provided guarantees for loans in favour of the Group amounting to HK$6,980 million (2007: HK$3,693 million) to certain third parties. BOC held equity interests of not more than 20% in these third parties.

(b) Advances acquired from BOC

During 2008, the Group has entered into an agreement with BOC to acquire advances amounting to USD300 million arising from trade finance facilities granted to customers. The outstanding amount of such advances at balance sheet date has been included as "advances to customers" in the financial statements.

51. Significant related party transactions (continued)

(c) Summary of transactions entered into during the ordinary course of business with BOC group companies

The aggregate income and expenses arising from related party transactions with the immediate holding company, the intermediate holding companies, associates of the Company as well as subsidiaries and associates of BOC are summarised as follows:

	Notes	2008		
		Immediate and intermediate holding companies HK$'m	**Associates HK$'m**	**Other related parties[1] HK$'m**
Income statement items:				
Interest income	(i)	**1,047**	**–**	**23**
Interest expense	(ii)	**(672)**	**(1)**	**(119)**
Insurance commission received (net)	(iii)	**–**	**–**	**9**
Administrative services fees received/ receivable	(iv)	**33**	**–**	**19**
Rental fees received/receivable	(iv)	**4**	**–**	**56**
Credit card commission paid/ payable (net)	(v)	**(56)**	**–**	**(3)**
Securities brokerage commission paid/payable (net)	(v)	**–**	**–**	**(322)**
Rental, property management and letting agency fees paid/payable	(v)	**–**	**–**	**(94)**
Funds selling commission received	(vi)	**–**	**–**	**70**
Correspondent banking fee received	(vii)	**13**	**–**	**–**
Net insurance premium income	(iii)	**–**	**–**	**1**
Loans services fees received		**–**	**–**	**2**
Net trading gains/(losses)		**692**	**–**	**(30)**

51. Significant related party transactions (continued)

(c) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

	Notes	2007		
		Immediate and intermediate holding companies HK$'m	Associates HK$'m	Other related parties[1] HK$'m
Income statement items:				
Interest income	(i)	596	–	25
Interest expense	(ii)	(442)	(3)	(332)
(Insurance premium paid)/insurance commission received (net)	(iii)	–	(2)	28
Administrative services fees received/ receivable	(iv)	33	–	43
Rental fees received/receivable	(iv)	–	–	29
Credit card commission paid/ payable (net)	(v)	(96)	–	(3)
Securities brokerage commission paid/payable (net)	(v)	–	–	(496)
Rental, property management and letting agency fees paid/payable	(v)	–	–	(82)
Funds selling commission received	(vi)	–	–	224
Correspondent banking fee received	(vii)	14	–	–
Loans services fees received		–	–	2
Net trading gains/(losses)		11	–	(96)

51. Significant related party transactions (continued)

(c) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

	Notes	2008		
		Immediate and intermediate holding companies HK$'m	**Associates HK$'m**	**Other related parties[1] HK$'m**
Balance sheet items:				
Cash and balances with banks and other financial institutions	(i)	**25,614**	**–**	**26**
Placements with banks and other financial institutions maturing between one and twelve months	(i)	**8,489**	**–**	**–**
Financial assets at fair value through profit or loss		**618**	**–**	**2,087**
Derivative financial instruments assets	(viii)	**782**	**–**	**4**
Advances and other accounts	(i)	**1**	**–**	**854**
Investment in securities	(i)	**1,280**	**–**	**–**
Other assets	(ix)	**55**	**–**	**2,050**
Deposits and balances of banks and other financial institutions	(ii)	**31,497**	**–**	**463**
Deposits from customers	(ii)	**97**	**46**	**8,019**
Derivative financial instruments liabilities	(viii)	**68**	**–**	**161**
Other accounts and provisions	(ix)	**99**	**–**	**2,210**
Subordinated liabilities	(x)	**27,339**	**–**	**–**
Off-balance sheet items:				
Contingent liabilities and commitments	(xi)	**9,037**	**–**	**4,222**

51. Significant related party transactions (continued)

(c) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

		2007		
	Notes	Immediate and intermediate holding companies HK$'m	Associates HK$'m	Other related parties[1] HK$'m
Balance sheet items:				
Cash and balances with banks and other financial institutions	(i)	22,854	–	30
Placements with banks and other financial institutions maturing between one and twelve months	(i)	8,917	–	–
Financial assets at fair value through profit or loss		438	–	2,097
Derivative financial instruments assets	(viii)	30	–	3
Advances and other accounts	(i)	21	–	–
Investment in securities	(i)	347	–	–
Other assets	(ix)	64	–	5,154
Deposits and balances of banks and other financial institutions	(ii)	15,478	–	680
Deposits from customers	(ii)	74	85	7,158
Derivative financial instruments liabilities	(viii)	14	–	23
Other accounts and provisions	(ix)	100	–	5,538
Off-balance sheet items:				
Contingent liabilities and commitments	(xi)	2,248	–	3,722

[1] Subsidiaries and associates of BOC and post-employment benefit plans for the benefit of employees of the Company are collectively disclosed as other related parties and certain of which are state-controlled entities.

Notes:

(i) Interest income

In the ordinary course of business, the Group enters into various transactions with BOC group companies including deposit of cash and balances with banks and other financial institutions, placement of interbank deposits, investment in securities and provision of loans and credit facilities. The transactions were conducted at prices and terms that are no more favourable than those charged to and contracted with other third party customers of the Group.

(ii) Interest expense

In the ordinary course of business, the Group accepts interbank deposits and current, fixed, savings and other deposits from BOC group companies at the relevant market rates at the time of the transactions. Interest on subordinated loans is charged at the contracted rate as denoted in Note 41.

(iii) Insurance premium paid/insurance commission received (net) and net insurance premium income

In the ordinary course of business, the Group renders insurance polices and agency services to and purchases general insurance policies from BOC group companies at the relevant market rates at the time of the transactions.

51. Significant related party transactions (continued)

(c) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

Notes: (continued)

(iv) Administrative services fees and rental fees received/receivable

In the ordinary course of business, the Group receives administrative services fees for the provision of various administrative services including internal audit, technology, human resources support and training to BOC group companies mainly on the basis of cost plus a margin of 5%, and receives office premises rental fees from BOC group companies at the relevant market rates at the time of the transactions.

(v) Commission, property management, letting agency fees and rental fees paid/payable

In the ordinary course of business, the Group pays commission fees for credit card administrative and promotional services, securities brokerage services, property management and letting agency fees to BOC group companies. The Group also pays rental fees to BOC group companies. These transactions have been entered into in the ordinary course of business and were priced at the relevant market rates at the time of the transactions.

(vi) Funds selling commission received

In the ordinary course of business, the Group receives commission for engaging in promotion and sale of fund products of a BOC group company to customers of the Group at the relevant market rates at the time of the transactions.

(vii) Correspondent banking fee received

In the ordinary course of business, BOC provides services to the Group's customers including remittance services and advising on and collecting letters of credit issued by the Group. The Group shares the fees paid by its customers with BOC on the basis agreed between the parties from time to time.

(viii) Derivative financial instruments assets/liabilities

In the ordinary course of business, the Group enters into foreign exchange contracts and interest rate contracts with BOC group companies. As at 31 December 2008 the aggregate notional amount of such derivative transactions amounted to HK$25,236 million (2007: HK$13,219 million) whilst the corresponding derivative financial instruments assets and liabilities amounted to HK$786 million (2007: HK$33 million) and HK$229 million (2007: HK$37 million) respectively. These transactions are executed at the relevant market rates at the time of the transactions.

(ix) Other assets and other accounts and provisions

Included within "Other assets" and "Other accounts and provisions" are receivables from and payables to BOC group companies. The amounts mainly represent the account receivables from and payables to a subsidiary of BOC in relation to dealing in securities trading transactions on behalf of the Group's customers. The receivables and payables arose from transactions carried out in the normal course of business.

(x) Subordinated liabilities

The Group entered into subordinated credit facility agreements with BOC for the purposes of capital management. Major commercial terms of the loans are stated in Note 41.

(xi) Contingent liabilities and commitments

In the ordinary course of business, the Group provides loan facilities and trade finance services to, and guarantees for the obligations of BOC and its subsidiaries and associates on normal commercial terms.

51. Significant related party transactions (continued)

(d) Key management personnel

Key management are those persons having authority and responsibility for planning, directing and controlling the activities of the Group, directly or indirectly, including directors and senior management. The Group accepts deposits from and grants loans and credit facilities to key management personnel in the ordinary course of business. During both the current and prior years, no material transaction was conducted with key management personnel of BOCHK, its holding companies and parties related to them.

The key management compensation for the year ended 31 December 2008 and 2007 is detailed as follows:

	2008 **HK$'m**	2007 HK$'m
Salaries and other short-term employee benefits	**53**	43
Post-employment benefits	**1**	1
	54	44

(e) Transactions with Ministry of Finance and The People's Bank of China

The Group enters into banking transactions with these entities in the normal course of business. These include purchases and redemption of treasury bonds and money market transactions. The outstanding balances at the year end, and the related income and expenses for the year are as follows:

	2008		2007	
	Interest income/ (expense) HK$'m	**Outstanding balance at end of the year HK$'m**	Interest income/ (expense) HK$'m	Outstanding balance at end of the year HK$'m
Advances and other accounts	**4**	**81**	8	120
Treasury bonds	**79**	**1,776**	62	1,600
Due from banks and other financial institutions	**660**	**51,769**	262	29,405
Due to banks and other financial institutions	**(1)**	**2**	(1)	1

51. Significant related party transactions (continued)

(f) Transactions with Central SAFE and other companies controlled by Central SAFE

Central SAFE is the controlling entity of BOC. Central SAFE is approved by the State Council of the PRC to assume the rights and obligations of the equity owner on behalf of the State. Accordingly, Central SAFE, acting on behalf of the State, has become the ultimate holding company of the Company by virtue of its interest in BOC.

The Group did not have any balances or enter into any transactions with Central SAFE for the year ended 31 December 2008 (2007: Nil).

Central SAFE has controlling equity interests in certain other entities in the PRC. The Group enters into banking transactions with these companies in the normal course of business. These include loans, investment securities and money market transactions. The outstanding balances at the year end, and the related income and expenses for the year are as follows:

	2008		2007	
	Interest income/ (expense) HK$'m	**Outstanding balance at end of the year HK$'m**	Interest income/ (expense) HK$'m	Outstanding balance at end of the year HK$'m
Advances and other accounts	**–**	**–**	–	23
Investment in securities	**196**	**5,479**	89	2,433
Financial assets at fair value through profit or loss	**–**	**20**	–	9
Due from banks and other financial institutions	**171**	**3,780**	85	1,443
Due to banks and other financial institutions	**(67)**	**1,214**	(21)	2,417

(g) Transactions with other state-controlled entities

The state-controlled entities are those, other than BOC (the intermediate holding company and its subsidiaries) and Central SAFE and its controlled companies over which the PRC government directly or indirectly holds over 50% of the outstanding shares or voting rights, and has the ability to control or the power to govern their financial or operational policies through its government authorities, agencies and affiliates. The Group has extensive transactions with other state controlled entities. These transactions, conducted in the ordinary course of business, may include, but are not limited to, the following:

- lending, provision of credits and guarantees and deposit taking;
- inter-bank balance taking and placing;
- sale, purchase, underwriting and redemption of bonds issued by other state-controlled entities;
- rendering of foreign exchange, remittance, investment related services;
- provision of fiduciary activities; and
- purchase of utilities, transport, telecommunication and postal services.

51. Significant related party transactions (continued)

(g) Transactions with other state-controlled entities (continued)

Utilities, transport, telecommunication and postal services are charged by service providers at market rates. Management believes that, based on their assessment, the amounts of such related party transactions are insignificant for the year and therefore are not disclosed.

Details of other transactions and balances with state-controlled entities conducted in the ordinary course of business are set forth below:

(i) Financial assets/financial liabilities

	2008		2007	
	Interest income/ (expense) HK$'m	**Outstanding balance at end of the year HK$'m**	Interest income/ (expense) HK$'m	Outstanding balance at end of the year HK$'m
Advances and other accounts (Gross)	**1,870**	**57,260**	1,899	39,828
Individually assessed loan impairment allowances	**–**	**122**	–	28
Investment in securities	**276**	**6,153**	323	7,158
Financial assets at fair value through profit or loss	**44**	**847**	31	1,219
Due from banks and other financial institutions	**107**	**2,155**	452	6,970
Due to banks and other financial institutions	**(237)**	**25,082**	(286)	18,667
Deposits from customers	**(808)**	**59,983**	(1,163)	29,927

(ii) Contingent liabilities and commitments (including guarantees)

	2008 HK$'m	2007 HK$'m
Contingent liabilities and commitments (including guarantees)	**43,866**	36,145

(iii) Outstanding derivative transactions (notional amount)

	2008 HK$'m	2007 HK$'m
Outstanding derivative transactions (notional amount)	**6,685**	1,686

52. Liquidity ratio

	2008	2007
Average liquidity ratio	**41.74 %**	50.92 %

The average liquidity ratio is calculated as the simple average of each calendar month's average liquidity ratio of BOCHK for the year.

The liquidity ratio is computed on the solo basis (the Hong Kong offices only) and is in accordance with the Fourth Schedule to the Banking Ordinance.

53. Currency concentrations

The following is a summary of the major foreign currency exposures arising from trading, non-trading and structural positions. The net options position is calculated based on the basis of delta-weighted positions of all foreign exchange options contracts.

	2008							
	Equivalent in million of HK$							
	US Dollars	**Japanese Yen**	**Euro**	**Australian Dollars**	**Pound Sterling**	**Renminbi Yuan**	**Others**	**Total**
Spot assets	**329,063**	**45,677**	**39,953**	**26,578**	**13,662**	**69,588**	**11,006**	**535,527**
Spot liabilities	**(282,888)**	**(10,671)**	**(26,033)**	**(28,009)**	**(16,730)**	**(68,161)**	**(22,252)**	**(454,744)**
Forward purchases	**328,459**	**28,024**	**31,497**	**17,948**	**18,249**	**22,282**	**39,376**	**485,835**
Forward sales	**(364,547)**	**(62,847)**	**(45,720)**	**(16,688)**	**(15,190)**	**(22,273)**	**(28,126)**	**(555,391)**
Net options position	**131**	**2**	**7**	**8**	**(9)**	**–**	**3**	**142**
Net long/(short) position	**10,218**	**185**	**(296)**	**(163)**	**(18)**	**1,436**	**7**	**11,369**
Net structural position	**158**	**–**	**–**	**–**	**–**	**1,719**	**–**	**1,877**

	2007							
	Equivalent in million of HK$							
	US Dollars	Japanese Yen	Euro	Australian Dollars	Pound Sterling	Renminbi Yuan	Others	Total
Spot assets	327,003	2,019	15,739	27,376	6,028	44,929	7,364	430,458
Spot liabilities	(224,622)	(4,764)	(9,215)	(24,055)	(12,951)	(44,055)	(19,615)	(339,277)
Forward purchases	159,983	22,718	25,775	22,051	25,907	26,760	43,162	326,356
Forward sales	(257,677)	(20,215)	(32,238)	(25,426)	(18,858)	(26,322)	(30,823)	(411,559)
Net options position	107	(16)	(17)	22	(5)	–	(9)	82
Net long/(short) position	4,794	(258)	44	(32)	121	1,312	79	6,060
Net structural position	84	–	–	–	–	459	–	543

54. Cross-border claims

The information on cross-border claims discloses exposures to foreign counterparties on which the ultimate risk lies, and is derived according to the location of the counterparties after taking into account any transfer of risk. In general, such transfer of risk takes place if the claims are guaranteed by a party in a country, which is different from that of the counterparty, or if the claims are on an overseas branch of a bank whose head office is located in another country. Only regions constituting 10% or more of the aggregate cross-border claims are analysed by geographical areas and disclosed as follows:

	Banks HK$'m	Public sector entities HK$'m	Others HK$'m	Total HK$'m
At 31 December 2008				
Asia, other than Hong Kong				
– Mainland China	**62,948**	**52,228**	**47,650**	**162,826**
– Japan	**19,475**	**39,462**	**1,522**	**60,459**
– Others	**46,292**	**54**	**16,293**	**62,639**
	128,715	**91,744**	**65,465**	**285,924**
North America				
– United States	**8,235**	**29,065**	**62,240**	**99,540**
– Others	**20,380**	**686**	**150**	**21,216**
	28,615	**29,751**	**62,390**	**120,756**
Western Europe				
– Germany	**37,262**	**664**	**1,252**	**39,178**
– Others	**135,312**	**353**	**6,992**	**142,657**
	172,574	**1,017**	**8,244**	**181,835**
Total	**329,904**	**122,512**	**136,099**	**588,515**

54. Cross-border claims (continued)

	Banks HK$'m	Public sector entities HK$'m	Others HK$'m	Total HK$'m
At 31 December 2007				
Asia, other than Hong Kong				
– Mainland China	56,017	30,926	29,699	116,642
– Japan	26,513	–	2,222	28,735
– Others	49,254	469	17,363	67,086
	131,784	31,395	49,284	212,463
North America				
– United States	9,726	27,179	78,144	115,049
– Others	18,081	95	68	18,244
	27,807	27,274	78,212	133,293
Western Europe				
– Germany	42,651	–	2,331	44,982
– Others	155,136	3	11,827	166,966
	197,787	3	14,158	211,948
Total	357,378	58,672	141,654	557,704

55. Non-bank Mainland China exposures

Non-bank counterparties are identified in accordance with the definitions set out in the prudential return "Quarterly Analysis of Loans and Advances and Provisions" issued by the HKMA. Exposures in Mainland China arising from non-bank counterparties at 31 December are summarised as follows:

	2008			
	On-balance sheet exposure HK$'m	**Off-balance sheet exposure HK$'m**	**Total exposure HK$'m**	**Individually assessed impairment allowances HK$'m**
Mainland China entities	**78,600**	**66,102**	**144,702**	**53**
Companies and individuals outside Mainland China where the credit is granted for use in Mainland China	**25,979**	**13,701**	**39,680**	**119**
Other non-bank Mainland China exposures	**14,095**	**7,824**	**21,919**	**56**
	118,674	**87,627**	**206,301**	**228**

55. Non-bank Mainland China exposures (continued)

	2007			
	On-balance sheet exposure HK$'m	Off-balance sheet exposure HK$'m	Total exposure HK$'m	Individually assessed impairment allowances HK$'m
Mainland China entities	60,275	44,693	104,968	23
Companies and individuals outside Mainland China where the credit is granted for use in Mainland China	23,142	17,535	40,677	13
Other non-bank Mainland China exposures	10,133	8,261	18,394	8
	93,550	70,489	164,039	44

56. Ultimate holding company

Central SAFE, acting on behalf of the State, is the ultimate holding company of the Company whilst BOC is the Company's intermediate holding company.

57. Approval of financial statements

The financial statements were approved and authorised for issue by the Board of Directors on 24 March 2009.